In the

Supreme Court of the United States

OCTOBER TERM, 1975

No. 74-1042

ERNST & ERNST, *Petitioner,*

vs.

OLGA HOCHFELDER, ET AL., *Respondents.*

ERNST & ERNST, *Petitioner,*

vs.

LEON S. MARTIN, ET AL., *Respondents.*

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

REPLY BRIEF FOR PETITIONER

ROBERT L. BERNER, JR.
FRANCIS D. MORRISSEY
MICHAEL J. MADDA
RICHARD M. FRANKLIN
BAKER & MCKENZIE
130 East Randolph Drive
Chicago, Illinois 60601
Attorneys for Petitioner Ernst & Ernst

Of Counsel
KENNETH H. LANG
925 Euclid Avenue
Cleveland, Ohio 44115

The Scheffer Press, Inc.—(312) 263-6850

INDEX

PAGE

Summary of Argument 1

Argument:

I. Respondents have not shown that they may predicate their Rule 10b-5 causes of action on allegations of negligence 11

II. Whether an implied cause of action arises from Section 17(a) of the 1934 Act and Rule 17a-5 thereunder is an issue not presented by the Petition for Certiorari and therefore has been improperly raised by the Allison Respondents. However, if this Court does address this issue, no such implied cause of action should be found 20

III. Petitioner as a matter of law exercised all due care and diligence and was not negligent or reckless in conducting its audits of First Securities 33

IV. Respondents' knowledge and conduct were such to cause their claims to be barred as a matter of law by the doctrine of equitable estoppel 54

V. Respondents' causes of action are barred by the applicable statute of limitations 58

Conclusion 67

Citations

PAGE

Cases:

Affiliated Ute Citizens v. *United States*, 406 U.S. 128 (1972) 23

Akron Presform Mold Co. v. *McNeil Corp.*, 496 F.2d 230 (6th Cir.), *cert. denied*, 419 U.S. 977 (1974) 10, 61

American Pipe and Construction Co. v. *Utah*, 414 U.S. 538 (1974) 9, 61

Antonioli v. *Lehigh Coal and Navigation Co.*, 451 F.2d 1171 (3d Cir. 1971), *cert. denied*, 406 U.S. 906 (1972) 64

Azalea Meats, Inc. v. *Muscat*, 386 F.2d 5 (5th Cir. 1967) 61, 63

Bailey v. *Glover*, 88 U.S. (21 Wall.) 342 (1875) 9, 58, 59

Barnett v. *United States*, 319 F.2d 340 (8th Cir. 1963) 47

Beecher v. *Able*, CCH Fed. Sec. L. Rep. §95,303 (S.D.N.Y. September 26, 1975) 52

Blue Chip Stamps v. *Manor Drug Stores*, —— U.S. ——, 44 L.Ed.2d 539 (1975) 2, 5, 14, 23, 26, 27, 30, 31

Bond & Goodwin, Inc., 15 S.E.C. 584 (1944) 37

Bowerman v. *Hamner*, 250 U.S. 504 (1918) 46

Brennan v. *Arnheim and Neeley, Inc.*, 410 U.S. 512 (1973) 22

Colonial Realty Corp. v. *Bache & Co.*, 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966) ..4, 23

Cope v. *Anderson*, 331 U.S. 461 (1947) 63

PAGE

Corning Glass Works v. *Brennan*, 417 U.S. 188 (1974) 7, 43

Donaldson v. *O'Connor*, 493 F.2d 507 (5th Cir. 1974), *vacated and remanded on other grounds*, —— U.S. ——, 45 L.Ed.2d 396 (1975) 64

Douglass v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912 (9th Cir. 1971) 59

Dlugash v. *SEC*, 373 F.2d 107 (2d Cir. 1967) 47

Fischer v. *Kletz*, 266 F.Supp. 180 (S.D.N.Y. 1967) 26

Fisher v. *Whiton*, 317 U.S. 217 (1942) 63

Gerstle v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973) 18

Hochfelder v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974) 6, 20, 34, 40, 41

Holmberg v. *Armbrecht*, 327 U.S. 392 (1946) 59, 61

Hooper v. *Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960) 59

Hupp v. *Gray*, 500 F.2d 993 (7th Cir. 1974) 61

In re Kamen & Co., 43 S.E.C. 97 (1966) 37

In re Penn Central Securities Litigation, 494 F. 2d 528 (3d Cir. 1974) 28, 30

International Ladies Garment Workers Union v. *Quality Manufacturing Co.*, —— U.S. ——, 43 L.Ed.2d 189 (1975) 3, 22

Janigan v. *Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965) 59, 63

J.I. Case Co. v. *Borak*, 377 U.S. 426 (1964) 23

Jones National Bank v. *Yates*, 240 U.S. 541 (1915) 47

PAGE

Kaiser v. *Cahn*, 510 F.2d 282 (2d Cir. 1974) 64

Kohn v. *American Metal Climax, Inc.*, 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972) ..2, 13

List v. *Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965) 14

McCaughn v. *Hershey Chocolate Co.*, 283 U.S. 488 (1931) 17

Moviecolor Ltd. v. *Eastman Kodak Co.*, 288 F.2d 80 (2d Cir. 1961) 60

Myzel v. *Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) 52

NLRB v. *International Van Lines*, 409 U.S. 48 (1972) 22

Parrent v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972) 60, 63

Rawlings v. *Ray*, 312 U.S. 96 (1941) 10, 63

Reid v. *Mann*, 381 F.Supp. 525 (N.D. Ill. 1974) .. 24

Remar v. *Clayton Securities Corp.*, 81 F. Supp 1014 (D. Mass. 1949) 23

Robert C. Herd & Co., Inc. v. *Krawill Machinery Corp.*, 359 U.S. 297 (1959) 31

Sargent v. *Genesco, Inc.*, 492 F.2d 750 (5th Cir. 1974) 59

SEC v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) 17

SEC v. *First Securities Co.*, 507 F.2d 417 (7th Cir. 1974) 32

SEC v. *Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973) 18

SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) 8, 51

PAGE

State Street Trust Co. v. *Ernst*, 278 N.Y. 104 (1938) 48, 49, 50

Stone v. *United States*, 113 F.2d 70 (6th Cir. 1940) 47

Superintendent of Insurance v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971) 23

Ultramares Corp. v. *Touche*, 255 N.Y. 170 (1931) 5, 31, 48, 49

United States v. *Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964) 18, 47

United States v. *United Mine Workers*, 330 U.S. 258 (1947) 17

United States v. *Wrightwood Dairy Co.*, 315 U.S. 258 (1942) 17

Vanderboom v. *Sexton*, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970) 59, 64

White v. *Abrams*, 495 F.2d 724 (9th Cir. 1974) 14

Zenith Radio Corp. v. *Hazeltine Research, Inc.*, 401 U.S. 321 (1971) 10, 64, 66

STATUTES AND RULES:

Equal Pay Act of 1963, 29 U.S.C. §206(d)(1) (1970) 44

Illinois Securities Law of 1953, §13D, Ill. Rev. Stat. ch. 121½, §137.13D (1973) 63

Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.* (1970) 29

Securities Act of 1933, §5, 15 U.S.C. §77e (1970) .. 47

Securities Act of 1933, §11, 15 U.S.C. §77k (1970) 13, 29

Securities Act of 1933, §12, 15 U.S.C. §77l (1970) 13, 27

PAGE

Securities Act of 1933, §15, 15 U.S.C. §77o (1970) 27

Securities Act of 1933, §17, 15 U.S.C. §77q (1970) 24

Securities Acts Amendments of 1975, §14, P.L. 94-29 (94th Cong., 1st Sess. 1975) 25

Securities Exchange Act of 1934, §6, 15 U.S.C. §78f (1970) 23

Securities Exchange Act of 1934, §7, 15 U.S.C. §78g (1970) 23

Securities Exchange Act of 1934, §9, 15 U.S.C. §78i (1970) 14, 15

Securities Exchange Act of 1934, §10(b), 15 U.S.C. §78j(b) (1970) .....
1, 3, 4, 11, 12, 13, 14, 15, 18, 19, 20, 21, 22, 23, 25, 27, 28, 46, 52

Securities Exchange Act of 1934, §12, 15 U.S.C. §78l (1970) 28, 29

Securities Exchange Act of 1934, §13, 15 U.S.C. §78m (1970) 28, 29, 30

Securities Exchange Act of 1934, §14, 15 U.S.C. §78n (1970) 18, 22, 23, 25, 29

Securities Exchange Act of 1934, §15, 15 U.S.C. §78o (1970) 22, 29

Securities Exchange Act of 1934, §17, 15 U.S.C. §78q (1970) .....
3, 4, 5, 12, 20, 21, 22, 24, 25, 26, 27, 28, 29, 30, 32, 33

Securities Exchange Act of 1934, §18, 15 U.S.C. §78r (1970) 4, 26, 27, 28, 30

Securities Exchange Act of 1934, §21, 15 U.S.C. §78u (1970) 17, 24

PAGE

Securities Exchange Act Rule 10b-5, 17 C.F.R. §240.10b-5 (1975) .....
1, 2, 3, 4, 5, 7, 10, 11, 12, 13, 15, 17, 18, 19, 20, 21, 23, 26, 27, 28, 30, 32, 43, 45, 46, 48, 51, 52, 53, 63, 66

Securities Exchange Act Rule 14a-9, 17 C.F.R. §240.14a-9 (1975) 18

Securities Exchange Act Rule 17a-5, 17 C.F.R. §240.17a-5 (1975) .....
3, 4, 5, 12, 20, 21, 22, 24, 25, 27, 28, 29, 30, 32, 33, 34

Securities Exchange Commission Rule of Practice 2(e), 17 C.F.R. 201.2(e) (1975) 24

U.S. Sup. Ct. R. 40(1)(d)(2) (1970) 22

U.S. Sup. Ct. R. 40(5) (1970) 51

Utility Holding Company Act of 1935, 15 U.S.C. 79 *et seq.* (1970) 29

OTHER AUTHORITIES:

A. M. Schlesinger, Jr., *The Coming of the New Deal* (1959) 16

Bucklo, Scienter *and Rule 10b-5*, 67 Nw.U.L. Rev. 562 (1972) 53

Hearings on S.84, S.56 and S.97 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. (1934) 16

2 *Moore's Federal Practice*, §3.07(2) (1974) 64

SEC Accounting Release No. 19 (McKesson & Robbins, Inc.) (December 5, 1940) 36

SEC Form X-17A-5, 17 C.F.R. §249.617 (1975) ..34, 41

Who Was Who in America, Vol. II 51

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1975

No. 74-1042

ERNST & ERNST, *Petitioner,*

vs.

OLGA HOCHFELDER, ET AL., *Respondents.*

ERNST & ERNST, *Petitioner,*

vs.

LEON S. MARTIN, ET AL., *Respondents.*

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

---

REPLY BRIEF FOR PETITIONER

SUMMARY OF ARGUMENT

I. The Hochfelder Respondents concede that ordinary negligence is insufficient for civil liability under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78 *et seq.* (1970) ("Section 10(b)" of the "1934 Act"), and Rule 10b-5, 17 C.F.R. §240.10b-5 (1975) ("Rule 10b-5"),

thereunder.* They contend instead that gross negligence is actionable under Rule 10b-5, but support their novel theory neither by reference to the language of the statute and the rule nor by citation of any other authority. As demonstrated in part I of Petitioner's main brief, no degree of negligence is sufficient to support a Rule 10b-5 damage action.

The position of the SEC and of the Allison Respondents is that negligent conduct may constitute a violation of Rule 10b-5 because the "effect" of manipulative or deceptive practices upon investors is no less when such effect results from negligent than from intentional conduct. This is patently incorrect since by the same reasoning innocent conduct resulting in an injurious effect upon investors would also be subject to the prohibition of Rule 10b-5. Congress clearly did not intend that innocent conduct be subject to Rule 10b-5 liability nor that the remedy implied under Rule 10b-5 expand beyond the bounds Congress authorized for the express causes of action under the securities laws. *See Kohn* v. *American Metal Climax, Inc.*, 458 F.2d 255, 280 (3rd Cir.), *cert. denied*, 409 U.S. 874 (1972); *Blue Chip Stamps* v. *Manor Drug Stores*, ... U.S. ....., 44 L.Ed.2d 539, 549-550 (1975).

---

* The brief submitted for Respondents Olga Hochfelder *et al.* (the "Hochfelder Respondents") is referred to hereunder as the "Hochfelder brief"; the brief for Respondents Allison, Carnovsky, Drake and Jacksons (the "Allison Respondents") as the "Allison brief"; the brief filed for the Securities and Exchange Commission (the "SEC"), *amicus curiae*, as the "SEC brief"; the brief for the American Institute of Certified Public Accountants (the "AICPA"), *amicus curiae*, as the "AICPA brief"; the petition for certiorari filed by Petitioner in these cases as the "Petition for Certiorari"; the brief on the merits filed by Petitioner in these cases as Petitioner's "main brief" and this reply brief of Petitioner as Petitioner's "reply brief."

The legislative history cited by the SEC, when read in the proper context, either supports Petitioner's position rather than that of the SEC and of the Allison Respondents, or is merely testimony before Congressional committees by individuals who played no role in the preparation or drafting of the 1934 Act and therefore should be accorded little weight.

The SEC fails to recognize that the issue before this Court is whether money damages may be recovered, not whether injunctive relief may be obtained, under Rule 10b-5 in the absence of proof of *scienter*. Thus, cases which have held that *scienter* is not an element of an SEC injunctive action do not support the position of the SEC. The policy arguments set forth by the SEC are supported exclusively by citation of cases which fail to deal with the question whether a certified public accountant should be held liable for damages under Rule 10b-5 in the absence of any proof of *scienter*.

Finally, the position of the SEC that a defendant may be held liable for money damages under Rule 10b-5 provided that three additional elements can be proved is unsupported by statutory construction or judicial decision and would require this Court to effect a legislative revision of Section 10(b) and Rule 10b-5.

II. The issue raised by the Allison brief dealing with whether a statutory duty and consequently a private right of action exist under Section 17(a) of the 1934 Act and Rule 17a-5, 17 C.F.R. §240.17a-5 (1975), thereunder was not raised by the Petition for Certiorari and, since the Allison Respondents failed to raise this issue by a counter-petition for certiorari, should be disregarded by this Court. *See International Ladies Garment Workers Union* v. *Quality Manufacturing Co.*, ... U.S. ....., 43 L.Ed.2d 189, 194 n.2 (1975).

Although this issue is not properly before this Court, civil liability cannot be implied from Section 17(a) of the 1934 Act and Rule 17a-5. Civil liability can only be properly implied from a statute which condemns or prohibits conduct as unlawful, and not from a provision like Section 17(a) which is merely directive in nature. *See Colonial Realty Corp.* v. *Bache & Co.*, 358 F.2d 178, 181 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966). Sufficient remedies other than civil liability are available to enforce auditing standards. Furthermore, the language of Section 17(a) indicates that Congress intended that the SEC, and not the investing public, be charged with the enforcement of this provision.

The existence of an express civil remedy under Section 18 of the 1934 Act against any person who makes any false or misleading statement in a document filed pursuant to the 1934 Act is strong evidence that no civil remedy should be implied under Section 17(a) of the 1934 Act or under Section 10(b) for the same conduct, or, at the very least, that any such implied cause of action should apply only to conduct as least as culpable as the conduct against which Section 18 is directed. Otherwise, plaintiffs will invariably proceed against accountants under the less exacting standards of an implied cause of action under Section 17(a) and Rule 17a-5 or under Section 10(b) and Rule 10b-5, and Section 18 will be rendered surplusage.

The consequence of the Allison Respondents' position is the implication of a cause of action against accountants for negligence in an audit in every instance when such audit is performed pursuant to the requirements of the federal securities laws. Recognition of an implied cause of action under Rule 17a-5 and the other provisions of

the federal securities laws which require the certification of financial statements would permit a plaintiff to sue an accountant under these provisions for a negligently certified audit even if the plaintiff was not a purchaser or a seller of a security. This would destroy, in the case of accountants, the protection against vexatious litigation recently extended to all Rule 10b-5 defendants in *Blue Chip Stamps* v. *Manor Drug Stores*, ... U.S. ....., 44 L.Ed.2d 539 (1975), which limits the class of plaintiffs with standing to sue under Rule 10b-5 to purchasers and sellers of securities. Furthermore, the position of the Allison Respondents would overrule, in the case of any audit performed pursuant to the requirements of the federal securities laws, the holding of *Ultramares Corp.* v. *Touche*, 255 N.Y. 170 (1931), which generally precludes plaintiffs from suing accountants in the absence of privity of contract when nothing more than negligence is alleged. There is no evidence that Congress intended to overrule *Ultramares* and the important policies supporting that case by enacting the federal securities laws.

Finally, even if a cause of action can be implied from Section 17(a) of the 1934 Act and Rule 17a-5, Petitioner owed no duty to Respondents since such statutory duty would run only to brokerage customers of First Securities with respect to their regular brokerage transactions and not to Respondents, who consciously permitted the "escrow" investments to be handled by Nay personally and thus were not customers of First Securities with respect to the "escrow" transactions, but of a separate venture conducted by Nay.

III. Respondents have submitted no evidence that the alleged audit deficiencies which they accuse Petitioner to

have committed constitute any violation of generally accepted auditing standards. The affidavits of Respondents' experts, which speak only to Nay's "mail rule," are not based on a review of any of Petitioner's work papers, documents or conduct with respect to its audits of First Securities, express only the personal opinions of the affiants and fail to speak to the critical issue whether Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards. The other authority cited by Respondents also fails to support their position that Petitioner was negligent with respect to Nay's mail rule. In the absence of any contrary evidence, Petitioner's affidavits, which are based on a complete review of Petitioner's audit work papers and documents and which conclude that Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards, must control.

The other alleged audit deficiencies are so utterly without merit that Respondents' expert witnesses did not comment upon them in their affidavits, they were summarily disposed of by the opinion of the Court of Appeals in the companion cases, *Hochfelder* v. *Midwest Stock Exchange,* 503 F.2d 364 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974), and they are totally unmentioned in the Seventh Circuit's opinion in these cases. Furthermore, the opinions of Petitioner's experts state that Petitioner's audits of First Securities were conducted in accordance with generally accepted auditing standards notwithstanding *any* alleged audit deficiencies. In the absence of evidence to the contrary, these affidavits must control.

Respondents have improperly raised the issue whether Petitioner's conduct in its audits of First Securities was sufficient under a *scienter* standard to give rise to Rule

10b-5 liability. Respondents never raised this issue prior to their briefs to this Court and the opinions of the courts below are based on the assumption that Respondents' claims will fail unless a cause of action for negligence can lie under Rule 10b-5. Accordingly, Respondents may not advance this alternative argument before this Court. *See Corning Glass Works* v. *Brennan,* 417 U.S. 188 (1974).

Although this issue is not properly before this Court, Petitioner's conduct in auditing First Securities as a matter of law could not constitute *scienter.* The cases cited by the Allison Respondents, although not decided under the federal securities laws, actually support Petitioner's position that its conduct was not sufficiently culpable to constitute *scienter.*

The Hochfelder Respondents erroneously suggest that gross negligence, as opposed to ordinary negligence, may properly give rise to Rule 10b-5 liability. Negligence of any degree is an insufficient basis for a Rule 10b-5 action. Furthermore, the authority cited by the Hochfelder Respondents fails to support their position that Petitioner was grossly negligent, reckless or heedless.

Since Respondents admit that Petitioner was not intentionally or willfully fraudulent with respect to its audits of First Securities, Respondents can prove *scienter* only if they can demonstrate that Petitioner was reckless with respect to its certification of such audits. In order to sustain a cause of action for reckless conduct under Rule 10b-5, the plaintiff must be able to prove either that the defendant knew of the falsity of his representation or that the defendant's conduct was so completely unfounded and without factual basis that the defendant must have known that it was equivalent to willful fraud.

See SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). The evidence before this Court is that Petitioner was not even negligent, much less reckless in its audits of First Securities. In any case, this is not an instance where Petitioner knew of the falsity of its audits or where Petitioner must have known that its audits were so completely unfounded and without factual basis that they were false. Accordingly, this Court can hold that as a matter of law Petitioner was not reckless in its audits of First Securities and that therefore its conduct was not sufficiently culpable to constitute *scienter*.

IV. The Allison Respondents' contention that Respondents were honest investors who did not know of Nay's fraud is unresponsive to Petitioner's estoppel argument. Petitioner's position is not that Respondents were dishonest nor that they knew of Nay's fraud, but that the uncontroverted facts in these cases require the conclusion that all Respondents consciously permitted their "escrow" investments to be handled outside of the books and records of First Securities by Nay and thus that all Respondents either knew, or should have known, that their "escrow" investments were investments with Nay personally and not with First Securities.

Petitioner's position rests not just on the audit confirmation forms on which no Respondent indicated that the statement of his account did not reflect his "escrow" investments, but on the uncontroverted facts that the entire course of dealing of all Respondents with respect to their "escrow" investments was outside of First Securities' books and records.

If Respondents thought that their "escrow" investments were investments with First Securities, it is clear that

Petitioner relied on Respondents, as reasonable investors, to raise an objection with First Securities, Petitioner or with some authority in light of the facts which must have indicated to Respondents that the "escrow" investments were outside of First Securities' books and records. If any Respondents believed that the "escrow" investments were investments with Nay and not with First Securities but that this practice was not irregular, such Respondents, by their conscious conduct, have waived the right to make any claim that Petitioner failed to discover Nay's fraud through its audits of First Securities' books and records.

Since all the elements of an equitable estoppel are present, Respondents are barred from their causes of action.

V. Respondents misinterpret *Bailey* v. *Glover*, 88 U.S. (21 Wall.) 342 (1875), to hold that a statute of limitations may be tolled in the absence of any act of fraud or fraudulent concealment on the part of the defendant. To the contrary, *Bailey* v. *Glover*, and each other case cited by the defendants in which the statute of limitations was held to be tolled, involved an act of fraud or fraudulent concealment on the part of the defendant. Furthermore, Respondents' contention that there is no federal doctrine of fraudulent concealment is particularly unfounded in light of this Court's very recent acknowledgment in *American Pipe and Construction Co.* v. *Utah*, 414 U.S. 538, 559 (1974), that "fraudulent concealment . . . by the conduct of the defendant" can toll a statute of limitations.

Although Respondents recognize that the statute of limitations cannot toll in any case if they failed to exercise due diligence in attempting to discover Nay's fraud, they have failed to place into the record before this Court any evidence which indicates that the Respondents were in fact exercising due diligence. In the absence of any such

showing, Respondents may not rely on the doctrine of fraudulent concealment to toll the applicable statute of limitations. *See Akron Presform Mold Co.* v. *McNeil Corp.*, 496 F.2d 230 (6th Cir.), *cert. denied*, 419 U.S. 997 (1974).

Respondents now contend for the first time in this litigation that two or three of Respondents made "escrow" investments with Nay within three years prior to the filing of their complaints in these cases and that the statute of limitations cannot be considered to have run against the causes of action of those defendants which allegedly arose from those investments.

Respondents improperly suggest that the date of accrual of a Rule 10b-5 cause of action is a question to be determined by state law, since this Court has held that even if a state statute of limitations is applicable to a federal right of action, the date of accrual of a plaintiff's cause of action is a question to be determined by federal law. *See Rawlings* v. *Ray*, 312 U.S. 96, 97-98 (1941). Employing the general federal rule set forth in *Zenith Radio Corp.* v. *Hazeltine Research, Inc.*, 401 U.S. 321 (1971), the dates when Respondents' causes of action accrued were the dates when Petitioner committed an "act" which injured Respondents. As the last "act" which could have injured any Respondent occurred in December, 1967, the date that Petitioner completed its last audit of First Securities, the causes of action of all Respondents are barred by the applicable three-year statute of limitations, unless Respondents can rely on the doctrine of fraudulent concealment.

ARGUMENT

I. RESPONDENTS HAVE NOT SHOWN THAT THEY MAY PREDICATE THEIR RULE 10b-5 CAUSES OF ACTION ON ALLEGATIONS OF NEGLIGENCE.

The Hochfelder Respondents apparently concede that ordinary negligence is insufficient for Rule 10b-5 liability, but contend that Petitioner's conduct in auditing First Securities may be characterized as grossly negligent and that such conduct is sufficiently culpable to give rise to Rule 10b-5 liability. *See* pages 6 and 10 of the Hochfelder brief. The Hochfelder brief reaches that position by ignoring the language of Section 10(b) and Rule 10b-5 and cites no other authority which supports the position that gross negligence, as opposed to ordinary negligence, is sufficient for private civil liability under the statute and the rule. For the reasons set forth in part I of Petitioner's main brief and in this part of this reply brief, negligence, no matter the degree, is never sufficient to support a Rule 10b-5 private damage action.

The SEC takes the position that Section 10(b) prohibits negligent conduct, but with the qualification that a defendant may be held civilly liable under Rule 10b-5 for negligence only where: (i) the defendant knew or had reason to believe that the plaintiff would rely upon the defendant's conduct, (ii) the plaintiff in fact did so rely and (iii) the amount of the plaintiff's damages resulting from the defendant's negligence is definite and ascertainable. *See* pages 10-33 of the SEC brief.

The Allison Respondents, with little independent discussion, adopt and incorporate the position of the SEC that Section 10(b) prohibits negligent conduct, but re-

ject the qualifications which the SEC would require for civil liability.* *See* pages 20-21, 37, 52-60 of the Allison brief.

a. The SEC Brief, Incorporated In This Respect By The Allison Respondents, Fails To Support Its Conclusion That A Rule 10b-5 Claim For Money Damages Can Be Predicated On Negligence.

Although the SEC brief alludes to the language of Section 10(b) and Rule 10b-5, to legislative and regulatory history, to judicial authority and to arguments of public policy, the position of the SEC is rooted in one argument. The SEC asserts repeatedly that, since the "effect" of manipulative or deceptive practices upon investors is no less when such effect results from negligent than from intentional conduct, Congress must have intended to bar all such practices and not just those done intentionally. *See* pages 11-15 of the SEC brief.

This argument is specious. By the same analysis, one could argue that a wholly innocent act or practice may result in a manipulative or deceptive effect upon investors equally adverse as an effect which is the result of purposeful, intentional or negligent conduct. This "effect-oriented" approach proposed by the SEC would accordingly require that purposeful, negligent and in-

* The Allison brief does include at pages 34-50 an extensive discussion which does not deal with Rule 10b-5 liability but which suggests that implied civil liability may arise from Section 17(a) of the 1934 Act and Rule 17a-5 thereunder. As Petitioner discusses at length in part II of this reply brief: (i) this issue was not presented by the Petition for Certiorari and is not properly before this Court, but (ii) if this Court does address this issue, civil liability cannot and should not be implied from Section 17(a) and Rule 17a-5.

nocent conduct be equally subject to the prohibition of Section 10(b) and Rule 10b-5, provided that such conduct results in a manipulative or deceptive effect upon investors. This extraordinary interpretation of the statute and rule would permit plaintiffs to proceed under Rule 10b-5 in every instance presently controlled by the express liability provisions of the securities laws and consequently would render surplusage the express liability provisions and the carefully drawn limitations on liability contained therein.* Moreover, plaintiffs could bring actions under this interpretation of Section 10(b) and Rule 10b-5 against a vast array of defendants, irrespective of the culpability of their conduct, whom Congress could not possibly have intended to subject to civil liability. As stated by Judge Adams in his concurring and dissenting opinion in *Kohn* v. *American Metal Climax, Inc.*, 458 F.2d 255, 280 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972), "[t]here is no evidence that Congress intended that under Section 10(b) anyone should be an

* *E.g.*, Section 11 of the Securities Act of 1933, 15 U.S.C. §77a *et seq.* (1970) (the "1933 Act"), expressly authorizes a person acquiring a security to bring an action against certain persons for negligent misstatements and against an issuer for innocent misstatements made in a registration statement. Section 12(2) of the 1933 Act allows a purchaser of a security to sue any person who offers or sells a security by means of a prospectus or oral communication which contains a negligent misrepresentation. Accordingly, where Congress intended to create liability under the federal securities laws for negligent or innocent conduct, it made clear provision for such liability. The Congressional design of limiting liability for negligent or innocent misrepresentations under Sections 11 and 12 of the 1933 Act to a limited class of defendants under a limited set of circumstances would be frustrated if plaintiffs could sue in any instance under Rule 10b-5 for any misstatement resulting in a manipulative or deceptive effect.

insurer against false or misleading statements made non-negligently or in good faith." *See also List* v. *Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); *White* v. *Abrams*, 495 F.2d 724, 728 (9th Cir. 1974).* Clearly, the consequences of the interpretation suggested by the SEC are contrary to the Congressional intent and purpose evidenced by the carefully structured scheme of the federal securities laws and would be violative of the admonition of this Court in *Blue Chip Stamps* v. *Manor Drug Stores*, ... U.S. ....., 44 L.Ed.2d 539, 549-550 (1975), that the scope of the implied cause of action under Rule 10b-5 should not expand beyond the bounds delineated by Congress for comparable express causes of action.

In support of its determination that Section 10(b) proscribes negligent conduct, the SEC also states, at page 12 of its brief, that where Congress intended to limit the reach of the 1934 Act to willful conduct it specifically did so. This is a half-truth. In *every* instance where Congress created an express liability provision under the securities laws, Congress specified whether willful, negligent or innocent conduct on the part of the defendant was the requisite culpability to give rise to civil liability. *See* pages 42-45 of Petitioner's brief. Thus, where Congress intended either to *limit* the reach of the securities laws to willful conduct or to *extend* the reach of the securities laws to negligent or innocent conduct, Congress made affirmative provision. Therefore, the inference which the SEC attempts to draw, that, since Section 9 of the 1934 Act is specifically addressed to willful conduct, Section 10(b) must be addressed to conduct irrespective of culpability, is patently incorrect. To the contrary, as set forth at pages 41-45 of Petitioner's main brief, the conclusion which best effectuates the overall regulatory scheme of the securities laws is that *scienter* is requisite to civil liability under Rule 10b-5.

* Inexplicably, the Allison brief acknowledges at page 57 that Respondents "are not contending for absolute liability."

The legislative history cited in the SEC brief also fails to support the conclusion that the scope of Section 10(b) extends to negligent acts. The statements of Thomas G. Corcoran, cited at pages 12-13 of the SEC brief, to the effect that negligence, in the absence of intent, may be the subject matter of a crime, are quoted without reference to their context. Mr. Corcoran was addressing himself to the question whether criminal penalties could arise from Section 8 of S.2693, 73d Cong. 2d Sess. (1934), the predecessor to Section 9 of the 1934 Act, in the absence of any requirement of intent on the part of the defendant. However, prior to the passage of the 1934 Act by Congress, Section 9(e) was amended to require willful participation as a prerequisite to liability for violations of Sections 9(a-c). *Compare* Section 9(e) of the 1934 Act *with* Section 8(c) of S.2693, 73d Cong. 2d Sess. (1934). Accordingly, Congress rejected Mr. Corcoran's suggestion that liability could arise in the absence of intentional conduct and this point of legislative history supports the position of *Petitioner*, not of the SEC.

Furthermore, the statements of representatives of the securities industry, cited at footnote 7 on page 13 of the SEC brief, that Section 10(b) might authorize the Commission to prohibit virtually anything, must be discounted. These statements were hyperbole used by the stock exchange and brokerage house representatives who were testifying before the House Interstate and Foreign Commerce Committee and the Senate Banking and Cur-

rency Committee to hinder the adoption of a statute which they claimed would have a disastrous effect on the securities markets.* History has disproved these witnesses' fears since, through proper interpretation of the 1934 Act

---

* *E.g.*, the testimony of Richard Whitney, President of the New York Stock Exchange, one of the securities industry leaders whose testimony the SEC cited, was given the following characterization in A. M. Schlesinger, Jr., *The Coming of the New Deal* 462-463 (1959):

> He [Whitney] had every objection to the bill. He opposed the effort to segregate the functions of brokers, floor traders, and specialists. He opposed the provision forbidding brokers to trade on their own accounts. Under the pretext of regulating the exchanges, he said, the bill gave the FTC "an absolute power to manage and to operate them." Under the guise of establishing sound practices, it aimed "to establish indirectly a form of nationalization of business." He addressed a personal letter to Roosevelt warning that the bill might result "in freezing the Stock Exchange, which is the market for liquid securities, just as effectively as the Securities Act has frozen the market for capital securities." If the bill passed, he told the House Commerce Committee, "the security markets of the Nation will dry up"; there would be "tremendous, if not universal, withdrawal" of corporations from the exchanges. More than this, the bill was unconstitutional. At bottom, indeed, he appeared to object not to this or that provision, but to the whole idea of federal regulation.

Similarly, Eugene E. Thompson, President of Associated Stock Exchanges, Washington, D.C., whose testimony the SEC also cited, warned the Congress that by enactment of the 1934 Act "you will have wrecked the stock exchanges as institutions; but the damage will not have ended there, for you will have turned the corporate securities business of the greatest industrial country in the world out of orderly channels and into the keeping of securities racketeers and bootleggers. . . ." Hearings on S.84, S.56 and S.97 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. 6980 (1934).

by this Court and the lower courts, the securities industry has been able to coexist with the regulatory scheme of the statute. Furthermore, this Court has stated that little consideration is to be given in the construction of a statute to remarks made in the course of legislative debate or hearings other than by those persons responsible for the preparation or drafting of the bill. *See United States* v. *United Mine Workers*, 330 U.S. 258, 276-277 (1947); *United States* v. *Wrightwood Dairy Co.*, 315 U.S. 110, 125 (1942); *McCaughn* v. *Hershey Chocolate Co.*, 283 U.S. 488, 493-494 (1931).

Petitioner does not contend, as asserted by the SEC at pages 16-17 of its brief, that Rule 10b-5 liability for negligent conduct depends upon the identity of the plaintiff. Petitioner's sole position with respect to this issue is that *scienter* is a requisite element of every implied cause of action for damages under Rule 10b-5. The SEC cannot support the position it has adopted in its brief by citing decisions holding that *scienter* is not necessary to an action for an injunction, while ignoring the statement of this Court in *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193 (1963), that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages."* Whether the SEC can obtain an injunction under the express provisions of Section 21 of the 1934 Act for a violation of Rule 10b-5 without a showing of *scienter* is not at issue here. As discussed at pages 45-53 of Petitioner's main brief, the

---

* However, Petitioner has *not* acknowledged, as asserted by the SEC at page 8 of its brief, that negligent conduct is a sufficient basis for an SEC injunctive proceeding. *See* the footnote at page 47 of Petitioner's main brief. As the SEC notes in footnote 10 at page 16 of its brief, the Courts of Appeals are in conflict on this issue.

vast majority of the cases decided by the lower courts has held that *scienter* is a requisite element to a private action for damages under Rule 10b-5.

The SEC further contends at pages 18-21 of its brief that application of the prohibitions of Section 10(b) and Rule 10b-5 is particularly necessary in the case of negligent conduct committed by accountants. However, none of the authority which the SEC cites, and which is summarized in the margin hereof, provides any direct support for this contention.* To the contrary, compelling reasons for the opposing view are set forth in the discussions of the policy interests militating against the application of a negligence standard to accountants under Section 10(b) and Rule 10b-5 at pages 53-60 of Petitioner's main brief and at pages 33-43 of the AICPA brief.

b. This Court Should Hold That Scienter Is A Requisite Element To Every Rule 10b-5 Action For Money Damages And Should Reject The Formulation Of The SEC Which Permits Recovery Of Damages For Negligence Under Certain Circumstances.

After arguing that negligent conduct may be sufficient to constitute a violation of Rule 10b-5, the SEC

---

* The SEC cites a case involving criminal conduct of an accountant in which the court specifically found willfulness on the part of the accountant, *United States* v. *Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied*, 377 U.S. 953 (1964); an SEC injunction action, *SEC* v. *Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973); a number of its own opinions in administrative proceedings (*see* footnote 12 at page 18 of the brief of the SEC); and a private damage action brought under Section 14(a) of the 1934 Act and Rule 14a-9, 17 C.F.R. §240.14a-9 (1975), thereunder in which the court held that proof of *scienter* is not always required in an action brought for false and misleading statements in proxy materials, but specifically distinguished Rule 14a-9 from Rule 10b-5 with respect to the *scienter* requirement, *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1298-1301 (2d Cir. 1973).

recognizes and shrinks from the undesirable and unreasonable consequences which would result from its conclusion. Accordingly, the SEC modifies its position by suggesting that the recovery of damages for negligent violation of the statute and the rule be conditioned upon proof that: (i) the defendant knew or had reason to believe that the plaintiff would rely upon the defendant's conduct, (ii) the plaintiff in fact did so rely and (iii) the amount of the plaintiff's damages resulting from the defendant's negligent violation is definite and ascertainable. The SEC contends that these three conditions reflect a "common thread" which runs throughout the various provisions allowing recovery of damages in the securities laws. *See* pages 23-33 of the brief of the SEC. The SEC does not, however, submit any evidence in the language or in the statutory and regulatory history of Section 10(b) and Rule 10b-5 or any support in the decided cases for allowing recovery of damages for negligence when these three elements can be proved. To the contrary, the theory of liability proposed by the SEC, although an imaginative piece of draftsmanship, is in conflict with the conclusions dictated by application of the principles of statutory and regulatory construction and interpretation which, as set forth at length at pages 29-60 of Petitioner's main brief, requires proof of *scienter* as a prerequisite to all actions for money damages under Section 10(b) and Rule 10b-5.

II. WHETHER AN IMPLIED CAUSE OF ACTION ARISES FROM SECTION 17(a) OF THE 1934 ACT AND RULE 17a-5 THEREUNDER IS AN ISSUE NOT PRESENTED BY THE PETITION FOR CERTIORARI AND THEREFORE HAS BEEN IMPROPERLY RAISED BY THE ALLISON RESPONDENTS. HOWEVER, IF THIS COURT DOES ADDRESS THIS ISSUE, NO SUCH IMPLIED CAUSE OF ACTION SHOULD BE FOUND.

a. This Issue Is Not Presented By The Petition For Certiorari And Therefore Has Been Improperly Raised By The Allison Respondents.

The Court of Appeals in these cases, citing its decision in the companion cases of *Hochfelder* v. *Midwest Stock Exchange,* 503 F.2d 364 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974), held that a cause of action may be maintained for aiding and abetting a violation of Section 10(b) and Rule 10b-5 if:

> . . . the party charged with aiding and abetting . . . but for a breach of duty of inquiry, should have had knowledge of the fraud, and possessing such knowledge the party failed to act due to . . . breach of a duty of disclosure. (Pet. for Cert. App. A 4a).

As demonstrated at pages 32-35 of Petitioner's main brief, the above-stated formulation of the Court of Appeals is a negligence standard whereby a plaintiff may proceed against a defendant under Rule 10b-5 without any allegation or proof of *scienter.* Accordingly, this Court granted its writ of certiorari to decide whether a plaintiff may predicate a cause of action against a defendant for a violation of Rule 10b-5 on an allegation of negligence. (Pet. for Cert. 2).

The Court of Appeals, having recognized that any suit grounded in negligence must be based on the breach

of some duty, also held that, although no common law duty was owed by Petitioner to Respondents, a statutory duty was imposed by Section 17(a) of the 1934 Act ("Section 17(a)"), and Rule 17a-5, 17 C.F.R. §240.17a-5 (1975) ("Rule 17a-5"), thereunder. (Pet. for Cert. App. A 4a-12a). As discussed in the footnote at pages 33-34 of Petitioner's main brief, Petitioner believes that the Court of Appeals erred in holding that Petitioner owed a statutory duty to Respondents under Section 17(a) of the 1934 Act and Rule 17a-5, but did not raise this issue in its Petition for Certiorari.*

Nevertheless, the Allison brief sets forth at pages 34-50 an extensive argument dealing with the duty to Respondents which the Allison Respondents assert Section 17(a) and Rule 17a-5 imposed on Petitioner. This discussion is irrelevant to the issues presented by the Petition for Certiorari, since, if this Court holds that a plaintiff cannot proceed under Rule 10b-5 against a defendant if nothing more than negligence is alleged, such holding will preclude Respondents from their causes of action regardless whether or not Petitioner owed a duty to Respondents under Section 17(a) and Rule 17a-5 for any alleged breach of generally accepted auditing standards. The opinion of the Court of Appeals specifically noted that Petitioner could be sued under Rule 10b-5 "[w]ithout reaching the question of whether there is implicit in section 17(a) a direct duty flowing to the plaintiffs . . . ." (Pet. for Cert. App. A 6a). Respondents are therefore attempting to broaden or alter the holding of the court below by presenting an issue not set forth in the Petition for Certiorari. In so doing, Respondents

---

* The Court of Appeals did not find that an implied cause of action arises under Section 17(a) and Rule 17a-5. Nor has any court.

have violated Rule 40(1)(d)(2) of this Court which generally prohibits briefs from raising additional questions or changing the substance of the questions set forth in the petition for certiorari. If the Allison Respondents desired to extend or modify the holding of the Court of Appeals by arguing that their claims can be properly based on an implied cause of action under Section 17(a) and Rule 17a-5, the Allison Respondents should have raised this issue by a counter-petition for certiorari. *See, e.g., International Ladies Garment Workers Union* v. *Quality Manufacturing Co.*, ... U.S. ....., 43 L.Ed.2d 189, 194 n. 2 (1975); *Brennan* v. *Arnheim and Neely, Inc.*, 410 U.S. 512, 516 (1973); *NLRB* v. *International Van Lines*, 409 U.S. 48, 52 n. 4 (1972).

b. No Implied Cause Of Action Arises From Section 17(a) And Rule 17a-5.

Although this issue is not properly before this Court, no implied cause of action can result from Section 17(a) and Rule 17a-5, and, in any case, Petitioner owed no duty to Respondents under Section 17(a) and Rule 17a-5.

1. Civil liability under Section 17(a) is repugnant to the statutory language.

Section 17(a) requires national securities exchanges, members of such exchanges, registered securities associations and brokers or dealers which are members of national securities exchanges or which are registered pursuant to Section 15 of the 1934 Act to maintain such records as the SEC requires. Accordingly, Section 17(a) does not proscribe conduct as illegal but is *directive* in nature. Section 17(a) is therefore distinguishable on its face from Section 10(b) and Section 14(a) of the 1934

Act, both of which this Court has recognized as sources for implied civil liability, as the latter two sections provide specifically that certain conduct, as defined in the rules and regulations promulgated by the SEC thereunder, is "unlawful."*

In *Colonial Realty Corp.* v. *Bache & Co.*, 358 F.2d 178, 181 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966), in holding that no implied civil remedy arises under certain rules of the New York Stock Exchange and the National Association of Securities Dealers adopted pursuant to Section 6(b) of the 1934 Act, Judge Friendly stated:

> Implication of a private right of action may be suggested by explicit statutory *condemnation* of certain conduct and a general grant of jurisdiction to enforce liabilities created by the statute, as in cases under §§ 10 and 14 of the Act, . . . or from such considerations as the protection intended by the legislature and the ineffectiveness of existing remedies, administrative and judicial, fully to achieve that end. (Emphasis added).

In *Remar* v. *Clayton Securities Corp.*, 81 F. Supp. 1014, 1017 (D. Mass. 1949), a seminal case finding civil liability under Section 7(c) of the 1934 Act, Judge Wyzanski stated:**

---

* This Court acknowledged implied civil liability for a violation of Section 14(a) of the 1934 Act in *J.I. Case Co.* v. *Borak*, 377 U.S. 426 (1964), and for a violation of Section 10(b) and Rule 10b-5 in *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972); and *Blue Chip Stamps* v. *Manor Drug Stores*, ... U.S. ....., 44 L.Ed.2d 539 (1975).

** Section 7(c) of the 1934 Act provides that it is "unlawful" for a member of a national securities exchange

> [T]he rule is that where defendant's violation of a *prohibitory* statute has caused injury to plaintiff the latter has a right of action if one of the purposes of the enactment was to protect individual interests like the plaintiff's. (Emphasis added).

Similarly, in *Reid* v. *Mann*, 381 F.Supp. 525, 528 (N.D. Ill. 1974), Judge Will noted, in holding that no implied cause of action exists under Section 17(a) of the 1933 Act:

> It is well accepted that those protected by a *prohibitory* statute have a private right of action unless the legislature clearly indicates that no such right exists. (Emphasis added).

Accordingly, civil liability should only be inferred from a statute which condemns or prohibits conduct and not from a provision such as Section 17(a) of the 1934 Act which is merely directive of conduct.

Furthermore, an auditor's violation of generally accepted auditing standards in conducting an audit pursuant to Section 17(a) and Rule 17a-5 is subject to "existing remedies, administrative and judicial," sufficient to effectuate the purpose of the statute and rule. As discussed at pages 58-59 of Petitioner's main brief, an auditor violating generally accepted auditing standards in an audit conducted pursuant to the federal securities laws may be subject to discipline by the SEC under Rule 2(e) of the SEC Rules of Practice, 17 C.F.R. 201.2(e) (1975), and may be subject to SEC injunctive proceedings under Section 21(e) of the 1934 Act.

** (Continued)
or for a broker-dealer to extend or maintain credit or to arrange for the extension or maintenance of credit to or for any customer in contravention of the rules and regulations of the Board of Governors of the Federal Reserve System.

Moreover, in Section 17(a) Congress provided that the records required to be made and maintained pursuant to this provision be subject to examinations "by examiners or other representatives of the Commission as the Commission may deem necessary or appropriate in the public interest or for the protection of investors." By limiting access to these records to SEC examiners and representatives, Congress evinced an intention that the SEC, and not the investing public, be charged with the enforcement of the provisions of Section 17(a).*

Finally, the plain meaning of Section 17(a) is to authorize the SEC to impose record-keeping requirements on exchanges, members of exchanges, registered securities associations and brokers or dealers. Therefore, even if liabilities may arise with respect to an exchange, a member of an exchange, a registered securities association or a broker or dealer which fails to comply with the requirements imposed by the SEC, no civil liability may arise with respect to an accounting firm. *Compare* Section 10(b) and Section 14(a) of the 1934 Act, both of which are addressed not to a limited class of persons but to "any person," *with* Section 17(a).

---

* Section 14 of the Securities Acts Amendments of 1975, P.L. 94-29 (94th Cong., 1st Sess. 1975), amended Section 17(a) to require broker-dealers to send to their customers an annual financial statement, certified by an independent public accountant. Although Petitioner does not acknowledge that the 1975 amendment causes civil liability to arise under Section 17(a), the amendment is nevertheless evidence that under prior law accounting firms certifying financial statements pursuant to Section 17(a) and Rule 17a-5 owed no duty to the customers of a broker-dealer.

2. Congress did not intend that Section 17(a) be a source for civil liability.

The Allison Respondents fail to cite any legislative history which supports their argument that civil liability may flow from an accountant's violation of a rule promulgated under Section 17(a). To the contrary, the evidence is that Congress had no such intention.

Section 18 of the 1934 Act provides that any person who makes any false or misleading statement in any document filed pursuant to the 1934 Act is liable for damages to any person who purchases or sells a security in reliance on such statement at a price which was affected by such statement. This provision permits an express cause of action against an accountant for false or misleading financial statements prepared and filed pursuant to any provision of the 1934 Act, including Section 17(a). *See Fischer* v. *Kletz*, 266 F. Supp. 180, 189 (S.D.N.Y. 1967). Respondents did not file their actions against Petitioner under Section 18 since Petitioner could avail itself of the express defense provided in Section 18(a) that Petitioner "acted in good faith and had no knowledge that such statement was false and misleading" and because Respondents would be barred by the applicable statute of limitations set forth in Section 18(c), which is one year after discovery of the facts constituting the cause of action or three years after the date the cause of action accrued. Furthermore, by bringing their actions under Rule 10b-5 Respondents avoided the possibility that the court would require them to post a bond for costs, as is specifically authorized by Section 18(a).

In *Blue Chip Stamps, supra* at 559 n. 15, this Court suggested that no implied cause of action should lie under Rule 10b-5 for actions made a violation of the 1933 Act

and the subject of express civil remedies under the 1933 Act. Furthermore, in *Blue Chip Stamps, supra* at 549-550, this Court noted that "[i]t would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action." Similarly, no implied cause of action should lie under Section 17(a) and Rule 17a-5 or Section 10(b) and Rule 10b-5 for actions made a violation of the 1934 Act and the subject of express civil remedies thereunder or, at the very least, any such implied cause of action should apply only to conduct at least as culpable as the conduct against which the express causes of action are directed. A contrary conclusion would allow plaintiffs to proceed under Section 17(a) and Rule 17a-5 or under Section 10(b) and Rule 10b-5 in order to avoid the protections Congress afforded defendants in Section 18 by providing a specific defense that the defendant "acted in good faith and had no knowledge" of the falsity of the statement, by including a specific statute of limitations and by authorizing the court to require the plaintiff to post a bond for costs. Effectively, Section 18(a) would be rendered surplusage as plaintiffs would always proceed under the less burdensome requirements of an implied cause of action under Section 17(a) and Rule 17a-5 or Section 10(b) and Rule 10b-5. The Congressional purpose cannot have been to permit the carefully drafted provisions of Section 18 to be circumvented by implied causes of action under either Section 17(a) and Rule 17a-5 or Section 10(b) and Rule 10b-5.* Therefore, Sec-

---

* Furthermore, Respondents had an express cause of action against Nay under Section 12(2) of the 1933 Act for offering and selling the fraudulent "escrow" investments and against First Securities under Section 15 of

tion 18 of the 1934 Act should be the exclusive remedy for false or misleading financial statements prepared and filed under Section 17(a) and Rule 17a-5 or, at the very least, no implied cause of action should lie against an accountant for conduct which would not be sufficiently culpable to be actionable under Section 18. *Cf. In re Penn Central Securities Litigation,* 494 F.2d 528, 539-541 (3d Cir. 1974), in which the Third Circuit refused to recognize an implied cause of action under Section 13(a) of the 1934 Act, which requires issuers of securities registered pursuant to Section 12 of the 1934 Act to file information, documents and annual reports with the SEC, and held that Section 18(a) is the exclusive remedy for allegedly false and misleading information in documents prepared and filed pursuant to Section 13(a).

3. Important policy reasons militate against finding civil liability under Section 17(a) and Rule 17a-5.

Rule 17a-5 requires that certain members of national securities exchanges and certain brokers or dealers file a report of financial condition certified by an independent certified public accountant. If civil liability may arise under Rule 17a-5 for an accountant's negligence in preparing an audit required thereby, the inevitable corollary is that in every other instance where the federal securities

---

• (Continued)
the 1933 Act as a "controlling person" of Nay. As suggested in *Blue Chip Stamps, supra* at 559 n. 15, no cause of action should be implied under the 1934 Act where Congress has made an offense a violation of the 1933 Act and the subject of express civil remedies under the 1933 Act. Accordingly, since Congress provided Respondents with specific remedies under the 1933 Act against Nay and First Securities, no remedy should be implied under Section 10(b) and Rule 10b-5 or Section 17(a) and Rule 17a-5 to extend liability for Nay's actions to Petitioner.

laws and the rules and regulations of the SEC require that financial statements be audited by a certified public accountant, a civil right of action will also arise. Accountants certifying financial statements would be subject to civil liability under federal law for any negligence in the course of their audits whether such certification was required in connection with a registration statement filed pursuant to Section 11 of the 1933 Act or Section 12 of the 1934 Act, annual or other reports filed pursuant to Section 13 or Section 15(d) of the 1934 Act, proxy and information statements filed pursuant to Section 14 of the 1934 Act, records and reports filed pursuant to Section 17 of the 1934 Act or registration statements and annual reports filed pursuant to the Public Utility Holding Company Act of 1935, 15 U.S.C. 79 *et seq.* (1970), or the Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.* (1970). In effect, plaintiffs would obtain a federal cause of action against accountants for any negligence committed in the audit of any financial statement required to be filed under the provisions of the federal securities laws. This appears to be the position urged upon this Court by the Allison Respondents. The heading to section II of their brief at page 34 summarizes their argument:

> [W]here an auditor voluntarily accepts a federal statutory duty to perform an audit in accordance with generally accepted auditing standards, it is liable in damages for its negligent conduct of the audit.

A particularly compelling reason to reject the Allison Respondents' argument is that to find a direct civil liability flowing from Rule 17a-5 and from every other instance where the federal securities laws require financial statements to be audited would destroy, in the case of accountants, the protection from vexatious litigation

recently extended to all potential defendants under Rule 10b-5 by the decision of this Court in *Blue Chip Stamps* v. *Manor Drug Stores,* ..... U.S. ..... 44 L.Ed.2d 539 (1975). No basis may be found in the language of Section 17(a) or Rule 17a-5, or in any other instance where the federal securities laws require the auditing of financial statements by a certified public accountant, to restrict the class of plaintiffs with standing to sue thereunder to purchasers and sellers of securities. Accordingly, the logical extension of the position which the Allison Respondents are urging on this Court is that any party claiming to have relied on financial statements prepared pursuant to the federal securities laws may sue the auditor of such financial statements for damages resulting from any alleged negligence. This would create the anomolous and unacceptable result that a plaintiff who was neither the purchaser nor the seller of a security would be barred by the holding of *Blue Chip Stamps* from suing a party who was actively fraudulent in connection with the offer of such security under Rule 10b-5, but the same plaintiff might nevertheless have a cause of action under Rule 17a-5 against an accountant who in connection with the offer negligently certified financial statements which failed to reveal the fraud. *Cf. In re Penn Central Securities Litigation, supra* at 540-541, in which the Third Circuit held that no implied cause of action exists under Section 13(a) of the 1934 Act, and recognized that finding such implied cause of action would have eliminated the purchaser-seller requirement in a civil action to remedy a violation of Section 13(a), otherwise essential in an action under either Rule 10b-5 or Section 18 of the 1934 Act.*

---

* Standing to sue under Section 18 of the 1934 Act is specifically limited by the statutory language to persons who have "purchased or sold a security."

Finally, the thrust of the Allison Respondents' policy arguments set forth at pages 34-50 of their brief is that, by trading in securities, brokerage customers assume a substantial risk of suffering losses as a result of fraud committed by brokerage firms. Even assuming this to be true, the Allison Respondents fail to approach the real issue in this case, which is whether a firm of certified public accountants which neither participated in nor benefited from a fraud should be held liable for the consequences of such fraud.

Three years prior to passage of the 1934 Act, Judge Cardozo, in *Ultramares Corp.* v. *Touche,* 255 N.Y. 170 (1931), formulated the rule that, in the absence of privity of contract, accountants are not liable for ordinary negligence in the performance of an audit. The Allison Respondents' positon with respect to implied liability would effectively overrule *Ultramares Corp.* v. *Touche* by creating a cause of action under the federal securities laws for any negligence committed by an accountant in connection with financial statements prepared pursuant to a provision of the federal securities laws. In the absence of specific evidence to the contrary, Congress cannot be assumed to have intended to overrule the well-established principle expressed in *Ultramares Corp.* v. *Touche* by enacting the securities laws. *See, e.g., Robert C. Herd & Co. Inc.* v. *Krawill Machinery Corp.,* 359 U.S. 297, 304 (1959). As set forth at pages 53-60 of Petitioner's main brief, strong policy arguments continue to militate against exposing accountants to unpredictable and enormous potential liabilities for acts of negligence. The words of Chief Judge Cardozo in *Ultramares Corp.* v. *Touche, supra* at 179-180, which are addressed to this precise issue and are cited with approval in the recent opinion of this Court in *Blue Chip Stamps, supra* at 556, bear repeating:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.

4. Petitioner owed no duty to Respondents under Section 17(a) and Rule 17a-5.

Even if a cause of action can be implied from Section 17(a) and Rule 17a-5, the SEC properly notes in footnote 25 at page 35 of its brief that any duty Petitioner may have had under this statute and rule ran only to First Securities' customers and that, since Respondents, with respect to the "escrow" investments, were not customers of First Securities but of a separate venture conducted by Nay personally, Petitioner owed no statutory duty to Respondents.

As discussed in detail in part IV of this reply brief, and as recognized by the Court of Appeals in *SEC* v. *First Securities Co.*, 507 F.2d 417 (7th Cir. 1974), Respondents were not customers of First Securities with respect to the "escrow" transactions. They were customers of Nay personally and First Securities' liability was only vicarious. Respondents have failed to respond to the uncontroverted facts in these cases which require the conclusion that Respondents consciously permitted the "escrow" investments to be handled outside of the books and records of First Securities and thus knew, or at least should have known, that the "escrow" investments were investments with Nay personally and not with First Securities. Because Respondents were not customers of First Securities with respect to the "escrow" investments, they were not the beneficiaries of any duty Petitioner may have owed First Securities' customers under Section 17(a) and Rule 17a-5.

III. PETITIONER AS A MATTER OF LAW EXERCISED ALL DUE CARE AND DILIGENCE AND WAS NOT NEGLIGENT OR RECKLESS IN CONDUCTING ITS AUDITS OF FIRST SECURITIES.

a. Petitioner Exercised All Due Care and Diligence In Accordance With Generally Accepted Auditing Standards In Conducting Its Audits Of First Securities.

The Allison Respondents assert at pages 9-15 of their brief that they are charging Petitioner "with four specific audit deficiencies in support of their cause of action." At pages 24-33 of their brief the Allison Respondents claim that these audit deficiencies are sufficient to raise genuine issues of material fact as to whether Petitioner negligently or recklessly violated generally accepted auditing standards in auditing First Securities. The Hochfelder Respondents address themselves only to Nay's "mail rule" and "vacation policy" and, since they appear to have conceded that ordinary negligence is insufficient to sustain their Rule 10b-5 causes of action, they argue only that Petitioner's conduct with respect to the "mail rule" and "vacation policy" was grossly negligent, reckless or heedless.* *See* pages 10-26 of the Hochfelder brief.

As set forth at greater length at pages 62-66 of Petitioner's main brief, First Securities engaged Petitioner

---

* Petitioner answers Respondents' contention that some or all of the alleged "audit deficiencies" may constitute gross negligence or reckless or heedless conduct in sections **b** and **c** of this part of Petitioner's reply brief.

to audit its financial statements as required by Rule 17a-5 and SEC Form X-17A-5, 17 C.F.R. §249.617 (1975). Petitioner's duty was to conduct its audits of First Securities in accordance with generally accepted auditing standards. Petitioner will discuss *seriatim* each of the "audit deficiencies" which Respondents allege Petitioner to have committed and will demonstrate that Petitioner as a matter of law breached no standard of care but conducted its audits of First Securities in accordance with generally accepted auditing standards.*

1. Nay's "mail rule" and "vacation policy."

The Allison Respondents erroneously assert at pages 9-11, 16, 27 and 51 of their brief that Petitioner had knowledge of Nay's "mail rule."** However, even if Petitioner

* The Allison brief states at page 19 that Petitioner's brief "inexplicably" views these cases as if the only charge against it was for negligence with respect to the "mail rule." The reason for this, as set forth below, is that the other charges are so completely without merit that (i) Respondents' expert witnesses did not comment upon them in their affidavits, (ii) these charges were disposed of in part by the opinion of the Court of Appeals in the companion cases *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974), and (iii) although Respondents raised these charges before the Court of Appeals, they are totally unmentioned, and thus by implication rejected, in the Seventh Circuit's opinion in these cases.

** There is no evidence in the record in these cases that Petitioner had knowledge of Nay's "mail rule." Petitioner's audit supervisors for the years in question did testify in their depositions that they had inspected First Securities' mail procedures, but none of them stated that they knew that Nay had an adamant policy that only he was permitted to open his own mail. (A. 192-194, 238-243, 305-309, 334-337).

had such knowledge, the uncontroverted evidence in these cases is that Nay's "mail rule" did not constitute a material inadequacy in First Securities' internal accounting control and that Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards.

The affidavits submitted by Petitioner in support of its motion for summary judgment were based on a review of all of Petitioner's work papers and documents with respect to its audits of First Securities. These affidavits provide competent expert testimony that Nay's "mail rule" did not constitute or result in a lack of internal accounting control at First Securities. Further, specifically assuming the existence of Nay's "mail rule," these affidavits provide competent expert testimony that Petitioner conducted its audits of First Securities, and in particular its review of First Securities' accounting system and internal accounting control and procedures, in accordance with generally accepted auditing standards.* (A. 103-106, 150-153).

The affidavits submitted by Respondents in opposition to Petitioner's motion for summary judgment are not based on any review of Petitioner's work papers or documents or on any knowledge of Petitioner's audits of First Securities and therefore are not competent evidence as to whether First Securities had adequate internal accounting control. Furthermore, Respondents' affidavits express only the personal opinions of the affiants and fail to speak

* Contrary to the Allison Respondents' suggestion at pages 23-24 of their brief, Petitioner's affiant John F. Walsh was an independent and disinterested expert. Mr. Walsh's testimony, when examined by Respondents on this point at his deposition, conclusively supports his independence. (A. 364-367).

to the essential issue whether Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards.* (A. 168-169, 172-176).

Accordingly, Respondents' affidavits fail to speak to the two critical issues: (i) whether Nay's "mail rule" was a material deficiency in the context of First Securities' overall internal accounting control and (ii) whether, notwithstanding the existence of Nay's "mail rule," Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards.

SEC Accounting Release No. 19 (McKesson & Robbins, Inc.) (December 5, 1940), cited at pages 14-18 of the Hochfelder brief, provides no support for Respondents' contention that Petitioner was negligent with respect to Nay's mail rule. In *McKesson*, the SEC did conclude that inadequate review of internal accounting control, including, among many other factors, mail procedures, may constitute a violation of generally accepted auditing standards. Petitioner concurs unreservedly with this conclusion. However, the uncontroverted evidence in the instant cases is that Petitioner did examine First Securities' incoming mail procedures (A. 192-194, 238-243, 305-309, 334-337), and the further uncontroverted evidence of Petitioner's expert witnesses, based on their review of Petitioner's audit procedures, is that Petitioner's audits of First Securities did include an adequate review of First Securities internal accounting control, implicitly including

* The Allison Respondents agree at page 21 of their brief that "the test of whether an auditor is negligent in connection with the auditing function is determined by asking whether he violated generally accepted auditing standards." However, Respondents' affiants failed to state whether Petitioner violated generally accepted auditing standards in its audits of First Securities.

Petitioner's review of First Securities' mail procedures, and that the audits were conducted in accordance with generally accepted auditing standards. (A. 104-106, 150-153).

Similarly, neither *Bond & Goodwin, Inc.*, 15 S.E.C. 584 (1944), nor *In re Kamen & Co.*, 43 S.E.C. 97 (1966), cited at pages 18-20 of the Hochfelder brief, supports Respondents' position. In each of these decisions the SEC found a broker-dealer culpable for lax control over its employees where the employees were engaging in a fraudulent course of conduct. These opinions turn upon a multitude of factors which required the SEC to conclude that the broker-dealers' supervision was inadequate and not, as the Hochfelder Respondents suggest, upon the single fact that the broker-dealers may have had inadequate control over their mail procedures. Additionally, of course, these decisions have no bearing whatsoever on whether an *auditor*, in accordance with generally accepted auditing standards, is required to discover and report a mail rule similar to Nay's. The uncontroverted evidence in these cases is that no such duty exists.

Finally, the Hochfelder Respondents' contention at pages 20-26 of their brief that Petitioner breached its duty to make appropriate inquiries concerning Nay's vacations is supported exclusively by a procedure set down by the Comptroller of Currency which requires national bank examiners to ascertain whether all employees of a bank which they are examining take an annual two-week vacation. The Hochfelder Respondents fail to present any evidence that procedures applicable to national bank examiners have any relevance to the procedures applicable to certified public accountants auditing a securities broker-dealer firm. In any event, the undisputed evidence

in these cases is that Nay regularly took vacations. (A. 96). Respondents' hearsay testimony cannot controvert this fact. (A. 70-71).

2. Petitioner's alleged awareness of other internal control deficiencies and lack of action.

The Allison Respondents suggest at pages 30-31 of their brief that Petitioner was negligent or reckless by not reporting that First Securities did not use pre-numbered receipts for cash and securities received from customers and did not send monthly statements to customers unless the customers requested them. However, the Allison Respondents provide no evidence whatsoever that Petitioner's conduct in this regard was in violation of generally accepted auditing standards. Even Respondents' incompetent affidavits fail to speak to the use of pre-numbered receipts and monthly statements. The uncontroverted evidence in these cases is that First Securities' internal accounting control was adequate and that Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards.*

Furthermore, the Allison Respondents have failed to demonstrate any causal connection whereby correction of these alleged internal control deficiencies would have resulted in the discovery of the fraudulent nature of the "escrow" investments. As discussed more fully in part IV of this reply brief, all Respondents, as regular securities customers of First Securities, did in fact receive confirmation of purchase or sale forms, receipts for securities tendered to First Securities for safekeeping and regular monthly statements with respect to their regular securities investments with First Securities. (A. 100). However, none of Respondents ever complained to First Securities, Petitioner or to any authority that they received none of these forms with respect to their "escrow" investments. (A. 108-109, 136, 138-139). Accordingly, there is no basis for Respondents' contention that the fraudulent nature of the "escrow" investments would have been revealed had Petitioner insisted that First Securities use pre-numbered receipts for cash and securities received and that First Securities send monthly statements to all of its customers.

* At page 24 of their brief, the Allison Respondents assert that Petitioner's motion for summary judgment and the affidavits of its experts respond only to the "mail rule" and fail to counter the other alleged audit deficiencies. This is totally erroneous. The opinions of both of Petitioner's experts are based on a complete review of all of Petitioner's records and documents relating to its audits of First Securities. They flatly conclude that Petitioner's audits of First Securities were conducted in accordance with generally accepted auditing standards, notwithstanding *any* alleged audit deficiencies.

3. Petitioner's alleged failure to determine the collectibility of large sums due First Securities from Nay.

The Allison Respondents claim at pages 31-32 of their brief that Petitioner's alleged failure to confirm the collectibility of certain debts owed by Nay to First Securities and to establish a reserve for such debts was negligent or reckless conduct. However, the Allison Respondents fail to provide any evidence or to cite any authority whatsoever that generally accepted auditing standards required Petitioner to make such confirmation or to insist on a reserve. Of course, the affidavits of Respondents' experts are silent on this matter. The fact is that the borrowings of Nay, the owner of 92% of the stock of First Securities, always represented less than the shareholders' equity

and earned surplus of First Securities and was fully discounted as an asset of First Securities when computing its net capital for regulatory and exchange purposes. Moreover, as pointed out in the companion cases *Hochfelder* v. *Midwest Stock Exchange,* 503 F.2d 364, 370-371 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974), Nay informed the Midwest Stock Exchange of these loans. The Seventh Circuit concluded that as a matter of law:

> The frequency of the borrowings and the total amount of the borrowings were not of such an unusual nature so as to put Midwest on notice of any wrongdoing by Nay.

Since these borrowings were found in the *Midwest* case to have been not of such an unusual nature to put the Midwest Stock Exchange on notice of any irregularity, these borrowings similarly could not have been of such a nature to put Petitioner on notice of any wrongdoing.*

Moreover, the Allison Respondents fail even to suggest any theory whereby the fraudulent nature of their "escrow" investments would have been disclosed had Petitioner taken steps to confirm the collectibility of Nay's debts or had Petitioner set up a reserve for these debts. Central to Respondents' theory of recovery is their claim that Petitioner failed to report certain deficiencies to the Midwest Stock Exchange and that Respondents relied on Nay's membership in the Midwest Stock Exchange. (A. 12-15). Furthermore, the answer of all Respondents to Petitioner's Interrogatory No. 80 was that Respondents' sole reliance on Petitioner's audit reports was through

---

* Both Petitioner and the Allison Respondents agree that on a motion for summary judgment a court may take judicial notice of facts established in prior proceedings. *See* page 28 of the Allison brief; page 4 of Petitioner's main brief.

". . . Nay's membership in the Midwest Stock Exchange which was based on these audit reports." (A. 83). However, the uncontroverted facts here are that the Midwest Stock Exchange *knew* of Nay's borrowings but failed to take any action. Accordingly, this alleged audit deficiency is irrelevant to Respondents' theory of recovery.

4. Petitioner's alleged concealment of a net capital violation, its alleged filing of a false audit certificate and its alleged preparation of a false Form X-17A-5 for the SEC.

The Allison Respondents contend at pages 32-33 of their brief that Petitioner was negligent or reckless with respect to certain violations of the net capital rules of the Midwest Stock Exchange which Petitioner allegedly failed to note on its 1967 audit and to report on SEC Form X-17A-5.

Once again the Allison Respondents have provided no evidence whatsoever that the actions which Respondents took with respect to this temporary net capital deficiency were in violation of generally accepted auditing standards. Respondents' expert witnesses did not and could not testify that, by not reporting the temporary net capital deficiency on its audit certificate or on Form X-17A-5, Petitioner violated generally accepted auditing standards. In the absence of such testimony, Petitioner's affidavits, based on a complete review of Petitioner's audits of First Securities, including Petitioner's treatment of the temporary net capital deficiency, must control. Furthermore, in *Hochfelder* v. *Midwest Stock Exchange, supra* at 371-372, the Seventh Circuit concluded that as a matter of law the net capital deficiency, even in light of the other "asserted warnings," was not sufficient to put the Midwest Stock Exchange on notice that further inquiry was

warranted. Surely Petitioner had no more obligation to enforce the rules of the Midwest Stock Exchange than did the Exchange itself.

Additionally, Jerry M. Hooker, Petitioner's audit supervisor at the time of the temporary net capital deficiency, notified the Midwest Stock Exchange by means of a memorandum of the deficiency. First Securities immediately corrected the deficiency and the vice-president and treasurer of the Midwest Stock Exchange informed Mr. Hooker in a telephone call that disclosure of this deficiency was inappropriate. (A. 214-215, 410). Therefore, this alleged audit deficiency once again has no relationship to Respondents' theory of recovery since the Midwest Stock Exchange had actual knowledge of the temporary net capital deficiency but failed to take any action.

In summary, Respondents have failed to place any evidence in the record in these cases that any of the alleged "audit deficiencies" were violations of generally accepted auditing standards. Moreover, the Allison Respondents concede at page 33 of their brief that whether Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards cannot depend on an "isolated set of facts but a comprehensive picture." The only evidence in these cases as to the "comprehensive picture" is that of Petitioner's experts, whose opinions, based on a full and complete review of Petitioner's audit documents and records, conclude that Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards. Respondents' affidavits, which are not based on any examination of Petitioner's audit documents and records and which do not

measure Petitioner's audits against generally accepted auditing standards, fail to provide any contrary testimony.*

b. Respondents Have Improperly Raised The Issue Whether Petitioner's Conduct Is Sufficient Under A Scienter Standard To Give Rise To Liability.

The Hochfelder Respondents, after conceding that Petitioner cannot be held liable for ordinary negligence, assert in their brief, for the first time in this litigation, that Petitioner's alleged failure to exercise proper or appropriate procedures in conducting its audits of First Securities is what the Hochfelder Respondents variously denominate as "gross negligence," "heedless conduct" or "reckless conduct" and is accordingly an appropriate basis for Respondents' causes of action. *See* pages 10-26 of the Hochfelder brief. Similarly, the Allison Respondents now raise the argument, novel in this litigation, that, if this Court holds that the element of *scienter* is required for Rule 10b-5 liability, the record discloses genuine issues of material fact as to whether Petitioner acted recklessly or with *scienter*. *See* pages 60-66 of the Allison brief.

The impropriety of asserting a novel theory of recovery before this Court when that theory has not been presented to the courts below is demonstrated by the recent decision of this Court in *Corning Glass Works* v. *Brennan*, 417 U.S. 188 (1974). Certiorari was granted in those consolidated cases since the Courts of Appeals for the

---

* Respondents had full and complete discovery and had ample opportunity to put into evidence proof that Petitioner's audits of First Securities, when viewed as a whole, were not conducted in accordance with generally accepted auditing standards. *See* the footnote at page 30 of Petitioner's main brief.

Second and Third Circuits had reached opposite conclusions concerning whether Corning Glass Works had violated the Equal Pay Act of 1963, 29 U.S.C. §206(d)(1) (1970), by paying a higher base wage to male night shift inspectors than it paid to female inspectors performing the same tasks on the day shift. One of the elements required in order to make out a case under the Equal Pay Act is a showing that the employer has paid wages to opposite sexes for work on jobs "which are performed under similar working conditions." Before the lower courts the Secretary of Labor had contended, and Corning Glass Works had disputed, that the day shift and the night shift work had been "performed under similar working conditions." The Secretary of Labor advanced the alternative argument before this Court, not raised before the lower courts, that even if night work and day work are assumed not to be performed under similar conditions, the differential in base wages was nevertheless violative of the Equal Pay Act. This Court refused at 417 U.S. 188, 197 n. 13 to consider this contention:

> This argument does not appear to have been presented to either the Second or the Third Circuit, as the opinions in both cases reflect an assumption on the part of all concerned that the Secretary's case would fail unless night and day inspection work was found to be performed under similar working conditions. For this reason, and in view of our resolution of the "working condition" issue, we have no occasion to consider and intimate no views on this aspect of the Secretary's argument.

In the instant cases the opinions of both courts below similarly reflect an assumption on the part of all concerned that Respondents' cases will fail unless negligence, the conduct Respondents were charging Petitioner to have

committed, is sufficient to state a cause of action for damages under Rule 10b-5.* No indication may be found in the opinion below or in the pleadings, briefs and other materials submitted by Respondents to those courts that Respondents were charging or could prove that Petitioner's conduct was any more culpable than ordinary negligence. For this reason, this Court should not consider Respondents' belated contention that Petitioner's conduct may be sufficient under a *scienter* standard to state a cause of action under Rule 10b-5.

c. Petitioner's Conduct As A Matter Of Law Did Not Constitute Scienter.

Although, as set forth above, this issue is not properly before this Court, Petitioner will nevertheless demonstrate hereunder that as a matter of law Petitioner's conduct in

---

* *E.g.*, the opinion of the Court of Appeals states that: "[i]n the instant action the plaintiffs claim that Ernst & Ernst was *negligent* in auditing First Securities thereby aiding and abetting Nay's Rule 10b-5 violation." (Pet. for Cert. App. A. 3a); "[p]laintiffs contend that Ernst & Ernst *negligently* failed to detect and report an alleged lack of adequate internal accounting controls of First Securities. . . ." (Pet. for Cert. App. A 13a); "the thrust of plaintiffs' action against the Midwest Stock Exchange, as here against Ernst & Ernst, was grounded in *negligence*. . . ." (Pet. for Cert. App. A 33a); ". . . Ernst & Ernst is charged with the *negligent* facilitation and implementation of Nay's fraud." (Pet. for Cert. App. A 34a). Similarly, the opinion of the District Court states that: "plaintiffs not only did not exercise diligence or care to discover Ernst & Ernst's alleged *negligence* but they actively participated in causing this defendant's failure to discover the fraud. . . ." (Pet. for Cert. App. B 36a); "[w]e find and conclude that defendant could be held liable on one or more legal theories for any *negligence* in auditing First Securities. . . ." (Pet. for Cert. App. B 39a). (Emphasis added).

auditing First Securities lacked the element of *scienter* necessary to give rise to liability under Rule 10b-5.

The Allison Respondents fail to cite any cases decided under Section 10(b) and Rule 10b-5 which support their contention that, in the admitted absence of any willful intent to defraud on the part of Petitioner, Petitioner's conduct in auditing First Securities was sufficiently culpable to constitute *scienter*.* At pages 61-66 of their brief, the Allison Respondents cite a number of cases decided either under the National Bank Act or under provisions of the securities laws other than Rule 10b-5, which hold that under the applicable factual circumstances the defendants had sufficient *scienter* for lability to arise. However, the Allison brief fails in its discussion of each of these cases to set forth the relevant facts which caused the court to find that the defendant's conduct was sufficient to result in liability. Read in light of their factual context, these cases, summarized in the margin hereof, might be analogous to an instance where an accountant certified financial statements in the absence of performing any audit functions, but clearly the principles expressed in these cases have no application to the facts in the present case.**

---

* The Answer of All Respondents to Petitioner's Interrogatory No. 74 was: "We do not accuse Ernst & Ernst of deliberate, intentional fraud." (A. 81).

** In *Bowerman* v. *Hamner,* 250 U.S. 504, 507-509 (1918), the conduct of the defendant bank director was found sufficient to give rise to liability under the National Bank Act where the director "never attended a single directors' meeting," "flagrantly disobeyed" the bank's by-laws which required the directors to attend regular meetings and generally to supervise the affairs of the bank and "surrendered wholly [the business of the bank] to the president and cashier." This Court stated at 250

** (Continued)
U.S. 510 that "even slight care in the discharge of his duties as a director" would have led the defendant to discovery of the mismanagement which was the basis of the plaintiff's suit. In *Jones National Bank* v. *Yates,* 240 U.S. 541 (1916), another National Bank Act suit, the failure of the defendant bank directors to perform their duties was likewise egregious. Similarly, in *Stone* v. *United States,* 113 F.2d 70 (6th Cir. 1940), the defendants were convicted for violations of Section 5(a)(1) of the 1933 Act. Although the defendants had denied that they knew they were lying, the Court of Appeals found that *scienter* could be inferred since the defendants had circulated a prospectus which stated, among other misrepresentations, that they could manufacture a television set with a retail price of $200 or less, when the only practical television being sold at that time cost $500 and when there was no evidence that the corporation possessed any such practical or feasible television or method for making one. Further evidence that the Allison defendants misread this case arises from the statement at page 63 of their brief that the Court of Appeals "sustained defendants' convictions." The convictions were in fact reversed. In *Barnett* v. *United States,* 319 F.2d 340 (8th Cir. 1963), immediately preceding the sentence quoted at page 63 of the Allison brief, the Eighth Circuit stated "[t]here is ample evidence that [the defendant] knew false and misleading statements were contained in the brochure." No such "ample evidence," nor in fact any evidence at all, is present in these cases that Petitioner knew that the First Securities' audit statements which it certified were false or misleading. Similarly, in *United States* v. *Benjamin,* 328 F.2d 854, 862 (2d Cir. 1964), the defendant "had actual knowledge of the falsity of his reports and deliberately conspired to defraud investors." Finally, *Dlugash* v. *SEC,* 373 F.2d 107, 109 (2d Cir. 1967), involved conduct of the defendants which was so extreme "that if they did not know, the circumstances were such that they should have" known of the relevant misrepresentations and manipulations.

The Hochfelder Respondents contend that either gross negligence or reckless or heedless conduct is sufficient to give rise to liability under Rule 10b-5. Gross negligence and reckless conduct are distinguishable concepts. Gross negligence is an act or omission involving a degree of negligence greater than that which constitutes ordinary negligence. Reckless conduct is tantamount to willful conduct and involves constructive knowledge that injury is likely to result from the act or omission. As set forth at length in part I of Petitioner's main brief and in part I of this brief, negligence, no matter the degree, is never sufficient to give rise to liability under Rule 10b-5. No case decided under the federal securities laws has drawn any distinction between gross and ordinary negligence. The proper standard for Rule 10b-5 liability is *scienter,* which Petitioner defines at page 31 of its main brief as actual knowledge or reckless or willful disregard of fraudulent conduct. Accordingly, this Court should reject the Hochfelder Respondents' contention that gross negligence is sufficient to give rise to Rule 10b-5 liability.

Furthermore, the authority cited by the Hochfelder Respondents fails to support their contention that Petitioner's conduct, even as characterized by Respondents, was sufficiently culpable to result in liability to Respondents.

At pages 10-12 of their brief, the Hochfelder Respondents rely on *State Street Trust Co.* v. *Ernst,* 378 N.Y. 104 (1938), to support their position. In the earlier case of *Ultramares Corp.* v. *Touche,* 255 N.Y. 170 (1931), the New York Court of Appeals had held that a public accountant could not be liable under state law for ordinary negligence to a party not in privity. In *State Street Trust Co.,* the court held that the defendant firm

of public accountants had actual knowledge that certain financial statements were materially inaccurate unless accompanied by an explanatory letter. The court found that the defendant had submitted the financial statements to its client without the explanatory letter but with full knowledge that the financial statements would be used to obtain credit. On these facts the New York Court of Appeals held that the defendant was liable to a creditor of the audited company which had relied on the financial statements.

The allegations in the present cases are actually much more similar to those in *Ultramares.* In that case, the defendant firm of public accountants was charged with negligence for failing to verify a ledger item representing accounts receivable against the journal, the "debit memo book" from which the journal was made up or the invoices which in the aggregate totaled the item in question. Additionally, there were grounds for suspicion arising from another item included in the accounts receivable, certain inflation in the value of inventory and the record of assigned accounts. Nevertheless, the defendant certified the balance sheet of the company under audit to be in accordance with its accounts and gave its opinion that the statement presented a true and correct view of the financial condition of the company under audit. In fact, capital and surplus, shown as intact on the balance sheet, were wiped out. Accordingly, *Ultramares* deals with a public accounting firm which was negligent because it failed to follow procedures required for a properly conducted audit, while *State Street Trust Co.* involves a public accounting firm which was held liable since it had actual knowledge that the financial statements the plaintiff was relying on were incorrect. Clearly, in the instant cases, Respondents are charging

Petitioner only with failing to follow a proper auditing practice and have offered no evidence whatsoever that Petitioner had actual knowledge that First Securities' financial statements did not reflect its true condition. Therefore, *State Street Trust Co.* provides no support for the contention of the Hochfelder Respondents that Petitioner was grossly negligent, reckless or heedless in its audits of First Securities.

As additional grounds that Petitioner was "grossly negligent" in conducting its audits of First Securities, the Hochfelder Respondents at pages 12-13 of their brief place great reliance on the Answer of all Respondents to Petitioner's Interrogatory No. 64, wherein Respondents stated that their counsel had been informed by a former president of the American Institute of Certified Public Accountants and by several other unidentified public accountants that it was "inexcusable negligence" for an auditor not to discover Nay's mail rule. This answer is inadmissable hearsay and is not competent evidence to controvert Petitioner's affidavits which attest that Petitioner conducted its audits in full accordance with generally accepted auditing standards. Similarly, Respondents' answer to Interrogatory No. 74, stating that Respondents were accusing Petitioner "with inexcusable negligence" is not evidence sufficient to controvert Petitioner's affidavits. In any case, the present claim of the Hochfelder Respondents set forth on page 13 of their brief, that an accusation of "inexcusable negligence" is equivalent to an accusation of "reckless" conduct is ludicrous. If Respondents were charging Petitioner with "excusable" conduct there would be no lawsuit.*

* At least twice in their brief, the Hochfelder Respondents themselves resort to flagrantly reckless comments

Those cases, totally unmentioned in either of Respondents' briefs, which discuss the circumstances under which reckless conduct, as opposed to negligence, may be sufficient to serve as the basis for a Rule 10b-5 cause of action indicate that a breach of duty amounting to reckless conduct is clearly distinguishable from the breach of duty which Respondents accuse Petitioner to have committed in its audits of First Securities.

For example, in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d. Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), an injunction issued against a corporation for negligence in the drafting of a press release. Judge Friendly, in his concurring opinion at 401 F.2d 868, in-

* (Continued)
concerning Petitioner, totally unsupported in the record, in an apparent effort to support their contention that Petitioner was reckless or grossly negligent in conducting its audits of First Securities. In footnote 5 at page 11 of their brief, they cite *Who Was Who in America* as evidence that Petitioner has undergone substantial growth in recent years and then state: "Such rapid expansion gives it [Petitioner] a problem in the recruitment, training, education and supervision of its employees." Absolutely nothing in the record in these cases supports Respondents' contention that public accounting firms which are expanding in size, or that Petitioner, in particular, has a "problem" of this or any nature. Similarly, at page 21 of their brief, they state that Petitioner did not have a checklist with respect to internal control similar to that used by national bank examiners and then assert: "Such a checklist would have been contrary to Ernst's policy of ingratiating itself with its clients." Absolutely nothing in the record in these cases serves to prove that Petitioner has or ever had a "policy of ingratiating itself with its clients." Furthermore, Petitioner in fact had and used a checklist with respect to internal control. (A. 195, 274). Scandalous remarks of this nature in a brief are in clear violation of Rule 40(5) of this Court.

dicated that the negligent misstatements in the press release were an inappropriate basis for the award of damages "as distinguished from the kind of recklessness that is equivalent to willful fraud. . . ." Similarly in *Myzel* v. *Fields,* 386 F.2d 718, 734 n. 8 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968), the Eighth Circuit approved the trial court's instruction which prohibited recovery under Rule 10b-5 against the defendants for certain expressions of opinion "unless the opinion was completely unfounded and reckless, or unless it was deliberately intended to be misleading."

In *Beecher* v. *Able,* CCH Fed. Sec. L. Rep. §95,303 at 98,536 (S.D.N.Y. September 26, 1975), the court held that the defendants neither had actual knowledge that a favorable forecast of corporate earnings set forth in a press release and a prospectus materially misrepresented the corporation's financial situation nor that the defendants acted in reckless disregard of whether the forecast was true. The court set forth the following definition of a reckless misrepresentation:

> In the context of actions alleged to be in violation of §10(b), a reckless misrepresentation can be defined as a highly unreasonable misrepresentation, involving not merely simple negligence, but an extreme departure from the standards of ordinary care, which presents a danger of misleading buyers or sellers that is either known to the actor or is so obvious that the actor must have been aware of it.

The court specifically noted that the defendants had some basis for concluding that the corporation would not have substantial losses for the relevant fiscal year and that "the existence of *some* basis in fact for making that predication indicates that defendant's conduct was not so highly unreasonable as to constitute recklessness or fraud."

Bucklo, Scienter *and Rule 10b-5,* 67 Nw. U.L. Rev. 562, 596 (1972), properly distinguishes negligence from reckless disregard of the truth. A defendant's misrepresentation is negligent, and not reckless, provided that the defendant "may be said to have had some factual basis for belief in the truth of (his) statement." Accordingly, a misstatement is reckless only if made totally without factual basis.

Summarizing the authority discussed above, in order to sustain a cause of action for reckless conduct under Rule 10b-5 for a misleading representation, the plaintiff must be able to prove either that the defendant knew of the falsity of his representation or that the defendant's conduct "was completely unfounded and reckless" or was without "factual basis," that it was "equivalent to willful fraud" and consequently that the defendant must have known of the falsity of his representation. As related to the instant facts, Respondents would have to prove that Petitioner either knew that its certifications of First Securities' financial statements were false or that such certifications were so completely unfounded and without factual basis that Petitioner must have known of their falsity.

The simple and complete answer to Respondents' contention that Petitioner was reckless is, as demonstrated in section **a** of this part of this reply brief, that Petitioner breached *no* standard of care in conducting its audits of First Securities, much less that Petitioner committed any act which could be characterized as reckless. Furthermore, even if this Court does find that Petitioner's audits could have contained one or more deficiencies, this is not an instance where an auditor recklessly or heedlessly certified an audit after performing no or few audit

functions. The uncontroverted evidence of Petitioner's audit supervisors for the years in question is that Petitioner performed an extensive and thorough audit. The further evidence of two expert certified public accountants is that Petitioner conducted its audits of First Securities in accordance with generally accepted auditing standards. Clearly this Court can hold that as a matter of law Petitioner was not reckless in its audits of First Securities.

IV. RESPONDENTS' KNOWLEDGE AND CONDUCT WERE SUCH TO CAUSE THEIR CLAIMS TO BE BARRED AS A MATTER OF LAW BY THE DOCTRINE OF EQUITABLE ESTOPPEL.

The Allison Respondents' answer to Petitioner's estoppel argument is that Respondents were "honorable and scrupulous," that Respondents were twelve investors, "completely disassociated from one another," who followed "a similar pattern of conduct" which is evidence that no "average reasonable investor" would have acted differently and that Nay's fraud and the fraudulent nature of the "escrow" investments were "facts that plaintiffs did not know and of which they had no constructive knowledge." *See* pages 66-72 of the Allison brief.

The Allison brief utterly fails to respond to Petitioner's contention, set forth in detail at pages 82-90 of Petitioner's main brief, that the doctrine of equitable estoppel bars Respondents' claims against Petitioner as a matter of law. Petitioner does not question Respondents' honesty, nor does it claim that Respondents knew of Nay's fraud, but bases its estoppel argument on the undisputed facts in these cases which require the conclusion that Respondents consciously permitted the "escrow" investments to be handled outside of the books and records of First Securities and thus that Respondents either knew, or

should have known, that the "escrow" investments were investments with Nay personally and not with First Securities. Respondents do not, and cannot, dispute that Petitioner was engaged to audit First Securities and not to audit Nay (A. 12, 103, 135, 138) and that any duty which Petitioner may have owed Respondents must be related to the books and records of First Securities and not to any personal investments with Nay. Since Respondents knew, or should have known, that the "escrow" investments were investments with Nay personally and not with First Securities, Respondents are now estopped from claiming that Petitioner should have discovered Nay's fraud through its examination of First Securities' books and records.

Both the Allison Respondents at pages 69-71 of their brief and the Hochfelder Respondents at pages 28-30 of their brief contend that Respondents cannot be held estopped as a matter of law since all Respondents did not receive audit confirmation requests and all Respondents who did receive audit confirmation requests did not have positions with respect to the "escrow" investments which should have been reflected on the requests. This vastly understates Petitioner's estoppel argument.

The failure of any Respondent to object to the statements of their accounts as reported on the audit confirmation requests is only one of many factors which require the conclusion as a matter of law that Respondents knew, or should have known, that the "escrow" investments were transactions with Nay personally and were outside the books and records of First Securities. As set forth in detail at pages 82-90 of Petitioner's main brief, all Respondents, as regular securities customers of First Securities, were accustomed to receive

confirmation of purchase or sale forms, regular statements, printed safekeeping receipt forms and other forms from First Securities with respect to their regular First Securities' brokerage accounts. Nevertheless, none of Respondents complained at any time to First Securities, Petitioner or to any authority that they did not receive such forms or other materials with respect to their "escrow" investments. Furthermore, as set forth at pages 4-6 of Petitioner's main brief, Respondents paid for the "escrow" investments by checks payable to Nay or to a bank for his account; Nay usually executed a handwritten document and sometimes gave his promissory note to Respondents in receipt of Respondents' cash investments; Nay paid the interest on the "escrow" investments by his personal check and annually sent to Respondents an Internal Revenue Service form which showed that the payments of interest had been reported by Nay as a deduction on his personal income tax returns; and, in connection with audits conducted by the Internal Revenue Service of Nay's personal income tax returns for certain years, Nay sent Respondents letters asking them to verify the amount of his personal indebtedness to them and the amount of interest he had paid them during the years.

At page 72 of their brief, the Allison Respondents question whether Petitioner relied on Respondents' conduct with respect to the "escrow" investments and whether this necessary element to the bar of equitable estoppel is present. Clearly, if Respondents thought that the "escrow" investments were investments with First Securities, Petitioner relied on Respondents, as Petitioner would rely on any reasonable investor, to raise some objection with First Securities, with Petitioner or with some authority in light of the overwhelming facts which must

have indicated to Respondents that the "escrow" investments were outside of First Securities' books and records.* If, however, any Respondents believed that the "escrow" investments were investments with Nay and not with First Securities but that this practice was not irregular, such Respondents, by their conscious conduct, clearly have waived the right to make any claim that Petitioner failed to discover Nay's fraud through its audits of First Securities' books and records.

In light of Respondents' total failure to controvert the facts set forth above which compel the conclusion that Respondents knew, or should have known, that the "escrow" investments were investments with Nay personally and not with First Securities, and in light of Petitioner's obvious reliance on Respondents' conduct, the authorities which the Allison Respondents cite at pages 73-76 of their brief fail to provide any support for Respondents' position. This is clearly an instance where there are no material factual questions and this Court can hold as a matter of law that Respondents are barred by the doctrine of equitable estoppel.

---

* At page 31 of their brief the Allison Respondents claim that, had monthly statements been sent to Arnold Schueren, who was defrauded by Nay under circumstances unrelated to the instant cases, Schueren would have been put on notice of Nay's fraud on him and consequently the fraud on Respondents would have been revealed. The Allison Respondents are apparently admitting that any reasonable investor, upon discovery of a discrepancy in his monthly statements, would take appropriate action to explain or cure the discrepancy. Similarly Respondents, as "reasonable investors," if they in fact believed that the "escrow" investments were investments with First Securities and not with Nay personally, should have complained to First Securities, Petitioner or to some authority that the monthly statements they received failed to reflect the "escrow" investments.

V. RESPONDENTS' CAUSES OF ACTION ARE BARRED BY THE APPLICABLE STATUTE OF LIMITATIONS.

a. Respondents Cannot Depend On The Federal Doctrine Of Fraudulent Concealment To Toll The Applicable Statute Of Limitations Because (i) Petitioner's Alleged "Negligent Facilitation And Implementation Of Fraud" Cannot Toll The Statute And (ii) Respondents Did Not As A Matter Of Law Exercise The Requisite Due Diligence In Attempting To Discover The Fraud.

The Hochfelder Respondents at pages 30-32 of their brief and the Allison Respondents at pages 77-87 of their brief contend that there is no federal fraudulent concealment doctrine which requires an act of fraud or of fraudulent concealment on the part of the defendant to toll a statute of limitations. They argue that the mere fact that Respondents failed to discover Nay's fraud is sufficient to toll the applicable statute. Both the Hochfelder Respondents at page 31 of their brief and the Allison Respondents at pages 81-82 of their brief misinterpret the following passage from this Court's opinion in *Bailey* v. *Glover*, 88 U.S. (21 Wall.) 342, 348 (1875), in support of their position that this Court repudiated concealment on the part of the defendant as a necessary factor to the tolling of a statute of limitations:

> We also think that, in suits in equity, the decided weight of authority is in favor of the proposition that where the party injured by the fraud remains in ignorance of it without any fault or want of diligence or care on his part, the bar of the statute does not begin to run until the fraud is discovered, though there be no special circumstances or efforts on the part of the party committing the fraud to conceal it from the knowledge of the other party.

However, the defendant in *Bailey* v. *Glover* was the party accused of fraud for conveying his property to his relatives prior to filing a bankruptcy petition. Accordingly, all that the above-cited passage stands for is that, if a party *actively commits fraud*, that party does not necessarily have to take any special steps to conceal that fraud from the plaintiff in order to cause the statute of limitations to toll.

In accordance with the holding of *Bailey* v. *Glover*, every other case cited at pages 31-33 of the Hochfelder brief and at pages 82-85 of the Allison brief, and discussed in the margin hereof, in which a statute of limitations was found to have tolled, involved an actual act of fraud or fraudulent concealment on the part of the defendant.*

---

* In *Holmberg* v. *Armbrecht*, 327 U.S. 392 (1946), the defendants were charged with the active fraudulent concealment of their ownership of bank shares in order to avoid liabilities imposed on them by law to the bank's creditors; in *Janigan* v. *Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965), the defendant was charged with conscious misrepresentations in connection with his purchase of the plaintiff's securities; in *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), the defendants were alleged to have engaged in a fraudulent scheme which concealed the plaintiff's Rule 10b-5 cause of action; in *Douglass* v. *Glenn E. Hinton Investments, Inc.*, 440 F.2d 912 (9th Cir. 1971), the statute of limitations was held not to run in favor of an investment company and an employee-broker when the employee-broker was charged with having actively defrauded the plaintiff and the investment company with vicarious liability under Section 20 of the 1934 Act; and in *Vanderboom* v. *Sexton*, 422 F.2d 1233, 1236 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970), all of the defendants were charged with having "aided, abetted and conspired" to defraud the plaintiffs. The Allison Respondents' citation from *Sargent* v. *Genesco, Inc.*, 492 F.2d 750, 758 (5th Cir.

Unlike the defendants in those of the cases cited in the margin in which the statute of limitations was found to have tolled, Petitioner is not charged with any deliberate or intentional fraud or with knowledge of any such fraud. Respondents have been unable to cite any case in which the doctrine of fraudulent concealment was applied to toll a statute of limitations in the absence of deliberate or intentional fraud or knowledge of any such fraud on the part of the defendant. Furthermore, Respondents fail to provide any significant discussion of the cases cited at pages 101-103 of Petitioner's main brief which deal with this precise issue and which uniformly hold that a plaintiff may not avail himself of the doctrine of fraudulent concealment when the defendant has committed no act of fraud or of fraudulent concealment.

Furthermore, Respondents' contention that there is no federal doctrine of fraudulent concealment is particularly unfounded in light of the recent decision of this

---

• (Continued)

1974), is *dictum* as the court held that the plaintiffs' cause of action could under no circumstances be barred under the applicable six year New York statute of limitations and their citation from *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972), is similarly *dictum* since the court held that the plaintiffs could not rely on any tolling of the applicable statute of limitations because they had failed to show their due diligence. Finally, *Moviecolor Ltd.* v. *Eastman Kodak Co.*, 288 F.2d 80, 87 (2d Cir. 1961), supports *Petitioner's* position, as the defendants' motion to dismiss on the ground that the statute of limitations had run was granted since the plaintiff's complaint failed "to make out a case of concealment." The Second Circuit specifically noted at 288 F.2d 87 that in order to toll a statute of limitations, "[m]ere ignorance of evidence on which to establish a claim is not enough. . . ."

Court in *American Pipe and Construction Co.* v. *Utah*, 414 U.S. 538 (1974). As discussed at pages 100-101 of Petitioner's main brief, this Court specifically noted at page 559 of that opinion that *Holmberg* v. *Armbrecht* stands for the doctrine that "fraudulent concealment . . . by the conduct of the defendant" can toll a statute of limitations.

The Hochfelder Respondents at pages 32-33 of their brief and the Allison Respondents at page 87 of their brief acknowledge that the statute of limitations cannot toll in any case if Respondents failed to exercise due diligence in attempting to discover Nay's fraud. However, the Hochfelder Respondents take the position at page 32 of their brief that this is "wholly a question of fact and cannot be disposed of on motion for summary judgment." In support of this position, the Hochfelder Respondents cite one case, *Azalea Meats, Inc.* v. *Muscat*, 386 F.2d 5 (5th Cir. 1967), which contains some general language to the effect that, since the issue of due diligence involves the state of mind of the person whose conduct is at question, this issue should not be resolved on summary judgment. However, *Azalea Meats, Inc.* v. *Muscat* is distinguishable from the instant cases since the Fifth Circuit at 386 F.2d 10 specifically found a "factual issue" resulting from "facts in the record" indicating that the plaintiff's delay in filing its suit resulted from misrepresentations made by the defendants and not from a lack of due diligence. More closely on point are the opinions of the Sixth Circuit in *Akron Presform Mold Co.* v. *McNeil Corp.*, 496 F.2d 230 (6th Cir.), *cert. denied*, 419 U.S. 997 (1974), and of the Seventh Circuit in *Hupp* v. *Gray*, 500 F.2d 993 (7th Cir. 1974). As discussed at pages 110-113 of Petitioner's main brief, the

Courts of Appeals held in these cases that since the burden of proving "due diligence" lies with the plaintiffs who were attempting to rely on the doctrine of fraudulent concealment to toll the statute of limitations, and since there was no evidence in the record in either case supporting the plaintiffs' claim that they were exercising due diligence, judgment could be rendered on this issue on summary judgment or on the pleadings.

As set forth at length at pages 109-115 of Petitioner's main brief, Respondents have submitted absolutely no evidence demonstrating that any of them were exercising due diligence in attempting to discover Nay's fraud and therefore Respondents cannot depend upon the doctrine of fraudulent concealment to toll the statute of limitations. Additionally, even if the burden of proving due diligence is not Respondents', Petitioner has submitted sufficient evidence, uncontroverted by Respondents, from which this court can conclude as a matter of law that Respondents' knowledge and conduct were such that Respondents failed to exercise due diligence in attempting to discover Nay's fraud.

b. All Respondents' Causes Of Action Are Barred By The Applicable Statute Of Limitations Unless The Statute Has Been Tolled By The Federal Doctrine Of Fraudulent Concealment.

At pages 88-92 of their brief, the Allison Respondents contend that a cause of action accrued against Petitioner at each date when each Respondent made an "escrow" investment with Nay. The Allison Respondents then conclude that since two or three of Respondents may have made "escrow" investments with Nay within three years prior to the filing of their complaints in these cases, the applicable statute of limitations cannot be considered

to have run against the causes of action of those Respondents which allegedly arose from those investments.

The sole case decided under the federal securities laws which the Allison Respondents cite in support of their position is *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972). Petitioner and the Allison Respondents are in agreement that in *Parrent* v. *Midwest Rug Mills, Inc., supra* at 125-128, the Seventh Circuit properly applied the three year statute of limitations of Section 13D of the Illinois Securities Law, Ill. Rev. Stat. ch. 121½, §137.13D (1973), to the plaintiffs' Rule 10b-5 cause of action. However, the Allison Respondents contend that the Seventh Circuit at 455 F.2d 12 also properly incorporated Illinois law in the respect that under the state blue sky law the cause of action of a buyer commences "not only from the date the right first accrues but from the date the sale is completed."

In *Rawlings* v. *Ray*, 312 U.S. 96, 97-98 (1941), this Court held that, although a state statute of limitations was applicable in the absence of Congressional expression of a limitations period in a federal statute creating a right of action, "[t]he question as to the time when there was a complete and present cause of action so that the receiver could enforce by suit the liability imposed by the Comptroller's assessment is a federal question. . . ." *See also Fisher* v. *Whiton*, 317 U.S. 217, 220 (1942), and *Cope* v. *Anderson*, 331 U.S. 461, 464 (1947). In accordance with these decisions of this Court, the vast majority of the Courts of Appeals has held that the date of accrual of a Rule 10b-5 cause of action is a federal question, notwithstanding that the limitation period is borrowed from state law. *See, e.g., Azalea Meats, Inc.* v. *Muscat*, 386 F.2d 5, 8 (5th Cir. 1967); *Janigan* v. *Taylor*, 344 F.2d

781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1964); *Vanderboom* v. *Sexton*, 422 F.2d 1233, 1240 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970). Similarly, with respect to other federal statutes which do not specify an applicable statute of limitations, the Courts of Appeals have consistently held that the date of accrual of the plaintiff's cause of action is determined by federal law even when the period of limitation is taken from state law. *See, e.g., Kaiser* v. *Cahn*, 510 F.2d 282, 285 (2d Cir. 1974); *Donaldson* v. *O'Connor*, 493 F.2d 507, 529 (5th Cir. 1974), *vacated and remanded on other grounds*, —— U.S. ——, 45 L.Ed. 2d 396 (1975); *Antonioli* v. *Lehigh Coal and Navigation Co.*, 451 F.2d 1171, 1175 (3d Cir. 1971), *cert. denied*, 406 U.S. 906 (1972). *See also* 2 *Moore's Federal Practice* §3.07(2), 749-750 (1974). Accordingly, the Allison Respondents' position that the Illinois Securities Law is dispositive of when their causes of action accrued is clearly incorrect.

As a matter of federal law, the last possible date that the cause of action of any Respondent could have arisen was December, 1967, the date when Petitioner issued its report with respect to the last audit of First Securities which Petitioner conducted as of October 31, 1967. (A. 103). As stated in *Zenith Radio Corp.* v. *Hazeltine Research, Inc.*, 401 U.S. 321, 338 (1971):

> Generally, a cause of action accrues and the statute begins to run when a defendant commits an act that injuries a plaintiff's business . . . . this has usually been understood to mean that each time a plaintiff is injured by an act of the defendants a cause of action accrues to him to recover the damages caused by that act and that, as to those damages, the statute of limitations runs from the commission of the act.

Therefore, employing the general federal rule, Respondents' causes of action could have accrued no later than December, 1967, the last date when Petitioner committed an "act" which could have injured any of Respondents. Since Respondents filed their initial complaints against Petitioner on February 19, 1971 and May 18, 1971, all Respondents are therefore barred by the applicable three-year statute of limitations unless they can avail themselves of the federal doctrine of fraudulent concealment.

Policy reasons also support Petitioner's position that the last date any cause of action of any Respondent accrued was the date of the last "act" of Petitioner which allegedly caused Respondents injury, rather than the date of Respondents' last "escrow" investment with Nay. The consequence of Respondents' position is that, given the present law in the Seventh Circuit, a new cause of action would accrue in favor of plaintiffs against a public accounting firm charged with negligently failing to discover fraud in the course of an audit for all subsequent purchases or sales of securities made by the party committing the fraud over an indefinite period of time. In more concrete terms, Respondents appear to contend that, even if Petitioner had conducted only one audit of First Securities in only one year in which it negligently failed to discover Nay's fraud, a new cause of action would accrue for each Respondent against Petitioner for each purchase of an "escrow" investment from Nay in any subsequent year. Particularly when a defendant is charged only with negligence, it is inequitable and contrary to the policies underlying statutes of limitations to expose a defendant to new causes of action, resulting in the statute of limitations running anew for each such cause of action, for each sale or purchase

of a security made subsequent to the defendant's alleged negligence.*

* The Allison defendants cite at pages 88-89 of their brief *Zenith Radio Corp.* v. *Hazeltine, supra* at 339, in which this Court held that under certain circumstances in antitrust treble-damage actions, a cause of action for future damages will accrue only on the date such damages are suffered. This holding should not be extended to statutes of limitations applicable to Rule 10b-5 actions, particularly, when the defendant is charged only with negligent conduct. However, even if this Court does adopt the exception to the general federal rule set forth in *Zenith Radio Corp.* v. *Hazeltine,* the only causes of action which would have accrued within three years of the dates Respondents' complaints were filed would relate to the "escrow" investments of Helen C. Allison made on March 7, 1968 and on March 19, 1968 and of Anna L. Jesse made on March 20, 1968. *See* Answer of Helen C. Allison to Petitioner's Interrogatory No. 40; Answer of Anna L. Jesse to Petitioner's Interrogatory No. 35. The causes of action of all the other Respondents, and of Respondents Allison and Jesse with respect to their other "escrow" investments, will be barred in any case by the statute of limitations, if this Court holds that Respondents may not avail themselves of the doctrine of fraudulent concealment.

CONCLUSION

For the reasons set forth in Petitioner's main brief and this reply brief, the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

ROBERT L. BERNER, JR.
FRANCIS D. MORRISSEY
MICHAEL J. MADDA
RICHARD M. FRANKLIN
BAKER & MCKENZIE
130 East Randolph Street
Chicago, Illinois 60601
Attorneys for Petitioner
Ernst & Ernst

Of Counsel
KENNETH H. LANG
925 Euclid Avenue
Cleveland, Ohio 44115